Decision **REVISED PROPOSED DECISION OF ALJ MASON**
(Mailed 5/20/2016)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of Application of Kerman Telephone Co. (U1012C) d/b/a Sebastian, to Review Intrastate Rates and Charges and Rate of Return for Telephone Service Furnished within the State of California, and to Modify Selected Rates.	Application 11-12-011 (Filed December 28, 2011)

(See Appendix D for list of Appearances)

DECISION ADOPTING INTRASTATE RATES AND CHARGES, RATE OF RETURN, AND MODIFYING SELECTED RATES FOR KERMAN TELEPHONE COMPANY

Table of Contents

Table of Contents (cont.)

Title **Page**

Table of Contents (cont.)

Title **Page**

DECISION ADOPTING INTRASTATE RATES AND CHARGES, RATE OF RETURN, AND MODIFYING SELECTED RATES FOR KERMAN TELEPHONE COMPANY

Summary

This decision authorizes a revenue requirement for Kerman Telephone Company (Kerman) as summarized in the following table, and discussed in greater detail throughout this decision and in Appendix A:

Rate Case Item	Kerman's Proposed Amount	Amount Adopted by this Decision
Operating Revenues	$10,442,787	$9,396,648
Operating Expenses	$7,474,394	$7,420,166
Average Rate Base	$12,956,237	$12,621,990
Rate of Return	13.74%	10.00%

As explained in this decision and in Appendices A and B, the adopted operating revenues include California High Cost Fund-A adopted support in the amount of $4,788,669.

This decision adopts basic residential rates of $30.00 per month and basic business service rates of $36.30 per month. These rates are inclusive of the Extended Area Service Charge and the Access Recovery Charge. The decision also adopts increased rates for custom calling features such as call waiting and caller ID that are reasonably comparable to the rates urban customers pay, pursuant to Pub. Util. Code § 275.5(c)(3).

With one exception, this decision adopts the proposals of the Office of Ratepayer Advocates regarding affiliate transactions.

This proceeding was submitted as of May 11, 2016, the date of the final oral argument.

Application 11-12-011 is closed.

1. Background and Procedural History

In December 28, 2011, Kerman Telephone Company d/b/a Sebastian (Kerman) filed this General Rate Case (GRC) application requesting review of its revenue requirement and an increase in net intrastate revenues of $2.957 million. At that time, Kerman's proposed increase in revenue requirement equated to a California High Cost Fund-A (CHCF-A) draw of $6.49 million for test year 2013. Kerman's GRC application did not request a change to its basic residential local exchange rate of $20.25 per month, but requested other selected rate changes such as charges for Extended Area Service, premises visits, inside wire, intra-building network cable, and returned checks. On January 26, 2012, the Division of Ratepayer Advocates[1] protested Kerman's GRC application requesting that it be stayed during the pendency of Order Instituting Rulemaking (OIR) Rulemaking (R.) 11-11-007, in which the Commission is currently conducting a detailed review of the CHCF-A program pursuant to Decision (D.) 10-02-016. The Office of Ratepayer Advocates (ORA)'s protest in Application (A.) 11-12-011 reflected the same concerns raised in its January 18, 2012, motion filed in R.11-11-007, i.e., to freeze the "waterfall" provisions of the CHCF-A,[2] stay A.11-12-011, and suspend processing all CHCF-A company GRC applications until completion of R.11-11-007. The Administrative Law Judge (ALJ) assigned to R.11-11-007 denied ORA's motion for a stay of A.11-12-011, finding that the request to stay should be considered in A.11-12-011.

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1 The Division of Ratepayer Advocates was renamed the Office of Ratepayer Advocates in September 2013.

2 Under the "waterfall" provision, a small Local Exchange Carrier's (LEC) CHCF-A subsidy level is set at 100% for the first three years following completion of a GRC, and reduced to 80% the fourth year, 50% the fifth year, and zero thereafter.

Subsequently, in R.11-11-007, on October 15, 2012, the Small LECs[3] filed a motion for a one-year freeze in the CHCF-A Rate Case Schedule and "waterfall mechanism."

On June 15, 2012, in A.11-12-011, following two prehearing conferences (PHCs), the Assigned Commissioner and ALJ issued a Scoping Memo and Ruling (June 15th Scoping Memo) that identified two threshold issues to be briefed and decided by the Commission prior to the scheduling of ORA's testimony and evidentiary hearings. The two "threshold" issues identified in Kerman's GRC were: 1) whether to freeze Kerman's revenue requirement and CHCF-A draw at current levels until the Commission concludes or reaches its decision in R.11-11-007, and 2) the timing of Kerman's future GRC filing if its CHCF-A draw and waterfall are frozen.

Upon request by the parties, the ALJ in A.11-12-011 extended the date for briefing the "threshold" issues twice, first to June 28, 2012, and then again to July 2, 2012. On June 29, 2012, Kerman and ORA submitted a Joint Motion for adoption of an all-party settlement and advised the ALJ that hearings would not be necessary. Among other things, the Settlement Agreement would have increased Kerman's CHCF-A draw by $831,735 for test year 2013.

The Commission rejected the settlement proposal in D.12-12-003, finding it was not reasonable in light of the whole record and not in the public interest, and thus fell short of the requirements for adoption of a settlement agreement set

[3] The Small LECs include Calaveras Telephone Co., Cal-Ore Telephone Co., Ducor Telephone Co., Foresthill Telephone Co., Kerman Telephone Company, Pinnacles Telephone Company, the Ponderosa Telephone Company, Sierra Telephone Company, Inc., the Siskiyou Telephone Company, and Volcano Telephone Company.

forth in Article 12 of the Commission's Rules of Practice and Procedure.[4] In addition, the Commission found that it was "premature to allow an increase in the CHCF-A draw for Kerman at this time."[5]

On January 9, 2013, Kerman filed a motion requesting immediate interim rate relief in the form of additional CHCF-A funds for calendar year 2013, and continuing until A.11-12-011 is fully adjudicated. Specifically, Kerman requested that the Commission grant it an additional $1,969,907 in CHCF-A funding for calendar year 2013 (for a total of $5,412,943) through interim rates, subject to true-up when a final decision issues in this proceeding.[6] Kerman's request equated to a 57% increase in its A-fund subsidy.[7]

On January 24, 2013, ORA filed a response opposing Kerman's motion for interim rate relief and recommending coordination of the issue of increasing Kerman's CHCF-A subsidy with the R.11-11-007 proceeding "to ensure consistent and nondiscriminatory treatment between the Small LECs."[8] On February 26, 2013, the Assigned Commissioner in A.11-12-011 issued an Amended Scoping Memo and Ruling, clarifying that since the issuance of D.12-12-003, the scope of the A.11-12-011 is now: (1) whether an interim rate increase is warranted; (2) should Kerman's GRC be stayed until completion of R.11-11-007; and (3) if the Kerman GRC application is stayed, should its CHCF-A

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[4] D.12-12-003, Conclusion of Law 4 at 15, line 1.

[5] D.12-12-003 at 8-9.

[6] Kerman Motion at 10, line 14.

[7] *Id.*

[8] January 28, 2013, ORA Response at 2.

draw be frozen at its current level of 100%. Parties filed opening and reply briefs on the identified issues on March 7, 2013 and March 21, 2013, respectively.

On February 20, 2013, the Commission issued D.13-02-005 in R.11-11-007, adopting a one-year stay of the Small LECs pending GRC proceedings and a one-year freeze in the Small LECs' CHCF-A waterfall provisions. Kerman was exempted from D.13-02-005. D.13-02-005 determined that Kerman's GRC request would be addressed in A.11-12-011.

On May 22, 2013, a Scoping Memo and Ruling of the Assigned Commissioner (Rulemaking Scoping Memo) was issued in R.11-11-007. The Rulemaking Scoping Memo adopted and confirmed the initial scope set forth in the OIR, and identified additional issues based on the comments, the results of the PHC and the passage of Senate Bill 379. The Rulemaking Scoping Memo adopted a procedural schedule, with a Proposed Decision anticipated in the fourth quarter of 2013.

On November 18, 2013, ORA filed a motion for an extension of the stay and freeze of D.13-02-005, which was granted on December 31, 2013. On March 18, 2014, the Assigned Commissioner in R.11-11-007 issued an Amended Scoping Memo and Ruling, revising the scope of the OIR and dividing it into two phases. Phase 1 of R.11-11-007 was scheduled to conclude with a decision issued by December 31, 2014.

D.14-08-010, issued on August 14, 2014, in R.11-11-007 extended the waterfall provision and freeze of the other Small LECs GRCs for another six months, with the potential for two additional extensions. The Phase 1 Decision (D.14-12-084) was issued on December 19, 2014.

2. The Stay of Kerman's Application

D.13-10-051, issued in A.11-12-011 on November 4, 2013, denied Kerman's motion for an interim rate increase requesting a total of $5,412,943 from the CHCF-A program, and ordered a stay of Kerman's pending rate case application (A.11-12-011) until December 31, 2013. D.13-02-005 also provides that the stay may be extended for up to six months.[9] D.13-10-051 also froze Kerman's CHCF-A draw at 100%.[10]

D.13-10-051, as modified by D.14-02-044, found that Kerman's request for interim relief would result in an even greater increase in the CHCF-A draw than the request denied by D.12-12-003. The Commission stated that it would continue processing A.11-12-011, and it intends to set rates in accordance with Public Utilities Code Sections 451, 454, 455, and 726, but must do so in an administratively feasible manner.[11] D.13-10-051, as modified by D.14-02-044, further ordered the rate proceeding to be adjudicated as soon as possible following the conclusion of R.11-11-007.

Another PHC was held on May 20, 2014. The PHC addressed, among other things, whether the stay imposed on A.11-12-011 should be extended, and if so, for how long. The PHC also addressed the updates to A.11-12-011 in light of the passage of time.

During the May 20, 2014 PHC, ORA requested a further extension of the stay granted by D.13-10-051 as modified by D.14-02-044, so that Kerman's

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[9] D.13-10-051 at 21.

[10] Other features of the CHCF-A program remain in effect during the freeze, e.g., annual CHCF-A funding adjustments via the Advice Letter process.

[11] Hereafter all statutory references are to the Public Utilities Code unless otherwise indicated.

pending GRC will proceed following issuance of a final decision in R.11-11-007.[12] Kerman objected to ORA's request.

On August 28, 2014, the Second Amended Scoping Memo and Ruling of the Assigned Commissioner and Administrative Law Judge was issued scheduling updated testimony be served no later than November 1, 2014, followed by intervenor testimony in March 2015. Evidentiary hearings were set for April 2015.

On November 3, 2014, Kerman filed a response to the Second Amended Scoping Memo and served updated testimony. Among other things, Kerman noted that Mr. Kehler provided updated testimony addressing Kerman's construction plans. Mr. Burke provided supplemental testimony updating his analysis in light of the passage of time. Mr. Clark's updated testimony is intended to replace his original testimony.

Kerman submitted a writ petition to the California Court of Appeals seeking review of both D.12-12-003 and D.13-10-051.[13] The Court declined to review the case on November 18, 2014.

On December 19, 2014, Kerman filed a Motion for Interim Rate Relief, requesting that ratemaking decisions adopted in this proceeding be effective as of January 1, 2015, and requesting an increase in its revenue requirement. ORA filed an objection to Kerman's request on January 5, 2015.

On January 9, 2015, ORA filed a Motion to Compel Production of Unredacted Customer Information.

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[12] Reporter's Transcript (RT) at 132:18-28.

[13] Kerman Telephone Co. d/b/a/ Sebastian v. The California Public Utilities Commission, F068856.

On January 16, 2015, Administrative Law Judge Halligan issued an e-mail ruling granting Kerman's request to respond to ORA's filing objecting to Kerman's request for Interim Rate Relief. On January 15, 2015, Kerman filed a reply to ORA's response to Kerman's Motion for Interim Rate Relief.

On January 21, 2015, Kerman and ORA submitted a joint motion to modify the procedural schedule to accommodate the submission of a supplement to Kerman's application to address the effects of D.14-12-084, the Commission's Decision Adopting Rules and Regulations in Phase 1 of the Rulemaking for the CHCF-A Program. Kerman and ORA also filed a joint request to shorten time to reply on the joint motion.

Kerman filed a response to ORA's Motion to Compel on January 26, 2015. By e-mail ruling dated January 30, 2015, ORA's Motion to Compel was granted.

In addition, on January 30, 2015, the Joint Motion of Kerman and ORA to Modify the Procedural Schedule was granted. Kerman served a supplement to its proposal and associated supplemental testimony on January 30, 2015. Kerman's supplemental testimony was intended to: 1) provide an updated rate design based on a modified local residential service rate that would bring Kerman within the range of reasonableness for basic, residential rates established in the Phase 1 Decision, and 2) a revised revenue requirement to account for the Federal Communications Commission's (FCC) cap on corporate operations expenses adopted in the Phase 1 Decision, along with information to rebut the appropriateness of applying the cap to Kerman.[14]

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[14] January 30, 2105, Kerman response at 1.

ORA served testimony on March 27, 2015 and Kerman's rebuttal testimony was served on April 16, 2015.

Four days of evidentiary hearings were held beginning on April 28 and ending on May 12, 2015.

Post-hearing opening briefs were filed and served on June 29, 2015.

Post-hearing reply briefs were filed and served on July 17, 2015.

This proceeding was reassigned to ALJ Robert M. Mason III on January 20, 2016, following the announcement that ALJ Halligan, who had been the ALJ assigned to this proceeding since April 29, 2013, accepted another position at the Commission.

On February 26, 2016, the Commission issued Decision 16-02-022, which granted Kerman's Third Motion for Interim Rate Relief. Kerman's interim relief was set at $1,112,373 and payable from the CHCF-A, and is subject to true-up and adjustment once the Commission reaches a final decision in this general rate case proceeding.

The proceeding was submitted following oral argument, which occurred on May 11, 2016 before a quorum of Commissioners.

3. Public Participation Hearing

On May 27, 2015, the Commission held a Public Participation Hearing at the Kerman High School, in Kerman, California, to take comment from the public. Speakers included the Kerman City Manager, Public Works Director, representatives from the Chamber of Commerce, employees of the City Of Kerman, the Superintendent of Kerman Unified School District as well as current and former school board members.

4. Legal and Policy Framework for this GRC

Under the Public Utilities Act, our primary purpose is to "insure the public adequate service at reasonable rates without discrimination…"[15]

Under Pub. Util. Code § 451, public utilities may demand and receive only just and reasonable charges, and they must provide "adequate, efficient, just and reasonable service" in a way that promotes the "safety, health, comfort, and convenience of [their] patrons, employees, and the public." Under Pub. Util. Code § 454, public utilities must make a showing to the Commission that any proposed rate change is justified, and receive a finding by the Commission to that effect before making such a change. Under Pub. Util. Code §§ 701 and 728, the Commission has the authority to determine what is just and reasonable, and to disallow costs not found just and reasonable. In particular, the Commission "has the power to prevent a utility from passing on to the ratepayers unreasonable costs for materials and services by disallowing expenditures that the Commission finds unreasonable."[16]

Pub. Util. Code § 275.6 requires the Commission to minimize telephone rate disparities between rural and metropolitan areas to keep rates affordable in areas with lower population densities. Specifically, Pub. Util. Code § 275.6(c)(2) requires that the Commission shall "employ rate of return regulation to determine a small independent telephone corporation's revenue requirement in a manner that provides revenues and earnings sufficient to allow the telephone corporation to deliver safe, reliable, high-quality voice communication service

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15 *Pacific Telephone and Telegraph Company v. Public Utilities Commission* (1950) 34 Cal.2d 822,836 [215P.2d 441].

16 *Id.*

and fulfill its obligations as a carrier of last resort in its service territory, and to afford the telephone corporation a fair opportunity to earn a reasonable return on its investments, attract capital for investment on reasonable terms, and ensure the financial integrity of the telephone corporation."

The intent of the CHCF-A is to provide a source of supplemental revenues to small Incumbent Local Exchange Carriers whose basic exchange access line service rates would otherwise be increased to levels that would threaten universal service. As stated in D.14-12-084, "[u]niversal, reliable, affordable, service is critical to public safety and benefits that state as a whole."[17]
The CHCF-A currently supports ten of the eligible thirteen small independent telephone companies to allow rural residents to stay connected to essential services to maintain public health and safety.

The CHCF-A program is funded by a surcharge assessed on revenues collected from end users of intrastate telecommunications services subject to surcharge. The Commission periodically reviews the program fund levels and adjusts the surcharge rate to ensure the program is sufficiently funded. All telecommunications carriers[18] and interconnected Voice-over Internet Protocol service providers[19] are required to assess the CHCF-A surcharge rate of 0.35%.[20]

In this GRC, as in all others, we seek to promote the public interest. However, promoting the public interest in this case requires that we carefully

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[17] D.14-12-084 at 53.

[18] See Pub. Util. Code § 275.

[19] See Pub. Util. Code § 285(c).

[20] Resolution T-17453, issued on November 21, 2014, set a surcharge rate of 0.35% effective January 1, 2015.

review the revenue requirement request of Kerman with an eye toward protecting not only Kerman's ratepayers and customers, but also all other carriers' customers that pay into the CHCF-A from which Kerman is requesting funding. In carrying out this responsibility, we assess whether Kerman has justified its revenue increase proposals and disallow those proposals to the extent that they have not been justified.

Kerman enjoys an effective monopoly in the provision of voice services in its service territory. Kerman therefore has the exclusive control over the costs and conditions of such service. Kerman also has exclusive control over the information about these costs and conditions. Of particular note in this proceeding is the fact that, while Kerman is requesting a significant increase in its revenue requirement, Kerman did not initially request an increase in its rates to support its requested revenue requirement increase. Instead, Kerman requested an increase in the CHCF-A subsidy.

Reflecting this concern, Pub. Util. Code § 275.6(b)(7) requires us to "ensure that [CHCF-A] support is not excessive so that the burden on all contributors to the CHCF-A is limited." Similarly, Pub. Util. Code § 275.6(f) states, "the Commission shall structure the CHCF-A program so that any charge imposed to promote the goals of universal service reasonably equals the value of the benefits of universal service to contributing entities and their subscribers." In its response to the ALJ's January 30, 2015 ruling, Kerman asked for $6,011,945 in CHCF-A support, which represents an increase in CHCF-A support of $2,472,220.[21]

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[21] Resolution T-17505 adopted $3,539,725 in CHCF-A funding for Kerman for calendar year 2016.

Pursuant to Pub. Util. Code § 309.5, consumer interests in this GRC are represented by ORA. ORA's statutory mandate requires it to pursue the lowest possible rates for ratepayers consistent with safe and reliable service. Despite ORA's participation in the case, the burden of presenting evidence of the need for its request never shifts from Kerman to ORA. The scope of our proceeding must include all relevant information necessary to determine whether the applicant's proposed revenue requirement and other requests are just and reasonable, and permit the utility to fulfill its duties under section 451.

Before leaving this section, we must address Kerman's additional comments regarding burden of proof that Kerman has raised since the evidentiary hearing. In its opening comments, Kerman errs in its suggestion that the decision uses varying standards for determining a ratepayer's burden of proof. It claims that the decision's requirement that Kerman establish how costs "enhance services to Kerman's customers," why costs "should be borne by the ratepayers," or why costs should be "underwritten" by the CHCF-A are burdens of proof inconsistent with and, therefore, not grounded in law. Yet such pronouncements in the decision are consistent with the fundamental rule of ratemaking "that it is the applicant who bears the burden of proof in a rate case to establish all the necessary facts which demonstrate entitlement to rate relief." (D.85-04-064, 17 CPUC 2d 724.) Kerman's reference to D.85-04-064 leaves out the qualifying word "all" before the word "facts" which wrongly suggests that the extent of its burden is somehow less than contemplated by this Commission. In ratesetting proceedings, Pub. Util. Code § 451 requires that the applicant demonstrate that the rates requested are "just and reasonable," and Pub. Util. Code § 454 states that rates may not be changed until the applicant shows and the Commission that a new rate is "justified." Thus, inquiries into why ratepayers should pay for expenses, how services will benefit Kerman's customers, and why costs should be underwritten by the CHCF-A are all part of that reasonableness burden that must be borne by the applicant.

Contrary to Kerman's supposition, a prior Commission decision is not sufficient for the applicant to meet its burden of proof in a new GRC. Kerman relies on D.11-05-018, 68, but this decision to not support argument. While the Commission discusses prior decisions as a means to satisfy an initial burden of proof, the Commission went further and added the following qualification:

> That PG&E demonstrated that its proposed treatment of the meters is consistent with the Commission's decisions in its AMI proceedings is sufficient with respect to meeting its initial burden of proof. However, providing such evidence does not necessarily ensure adoption or use of the proposal going forward. Certainly, elements of the revenue requirement calculation can be questioned in subsequent proceedings, just as PG&E's retired meter proposal was in this proceeding, and modified, if necessary, just as the Commission has done in this instance.

In other words, parties are entitled to challenge the continuing merits of a proposal previously adopted in a GRC.

Kerman is on unsound legal ground when it argues that the decision errs in its application of the ratepayer's burden of proof. Kerman cites Pub. Util. Code § 454 for the proposition that if Kerman fails to meet its burden of proof, then Kerman would be entitled to the existing rates. But the language of Pub. Util. Code § 454 does not support Kerman's position. In fact, we are not aware of any language in this cited section that states if new rates cannot be justified, the existing rates continue. Such a result would be contrary to the settled principle that ratesetting proceedings look to set rates for the future.

Finally, we believe it is necessary to discuss Commission precedent and the impact, if any, it has on a future Commission's ability to evaluate future GRCs. In its opening comments Kerman argues that the decision has reached an unreasonable result because the revenue requirement authorized is lower than the revenue requirement adopted as reasonable in Kerman's 2003 and 2008 rate cases. (Res. T-17081 (2008), App. A; D.03-10-006 (2003).) Kerman believes the error also extends to the decision's determination to reduce Kerman's CHCF-A support to an amount allegedly lower than the support adopted for Kerman in the last nine CHCF-A Resolutions. (Appendices of Res. T-17505, T-17461, T-17427, T-17385, T-17346, T-17298, T-17273, T-17181, T-17122.)

But Kerman places too much weight on the role of precedent. While the Commission can consider prior decisions as a guide, "the Commission is not bound by its precedent, unlike a court." (Decision 14-04-022, at 8, citing to *In re Pacific Gas & Electric Co.* (1988) 30 Cal.P.U.C.2d 189, 223-225; and *Postal Telegraph-Cable Company v. Railroad Commission* (1925) 197 Cal. 426, 436.) In *In re Pacific Gas,* the Commission explained that it is a "general rule of law that no legislative body can limit or restrict its own power or that of subsequent legislatures, and that the act of one legislature does not bind its successors." (30 Cal.P.U.C.2d at 223.) The Commission is both a court and an administrative tribunal that "exercises both judicial and legislative functions." (*Id*.) "The fixing of rates of public utilities is an example of its legislative powers." (*Id*., citing to *People v. Western Air Lines, Inc*. (1954) 42 Cal.2d 621, 630.) Accordingly, since the Commission "exercises legislative powers when it sets rates," a prior decision setting rates "would not bind successor Commissions." (30 Cal.P.U.C. 2d at 223.) As such, the amount of Kerman's CHCF-A support, as well as other legal determinations regarding Kerman's rate base, will ultimately be made by this Commission and based on the record developed in this proceeding.

We now apply the foregoing burden of proof and governing legal standards to the instant application.

5. Kerman

Kerman operates a telecommunications company that offers interexchange service to approximately 4,800 access lines in the central San Joaquin County City of Kerman and in the surrounding unincorporated areas of Fresno.[22] The City of Kerman is an agricultural and residential community located approximately 15 miles west of Fresno. Kerman is wholly owned and controlled by Sebastian Enterprises, Inc. (SEI), which is in turn owned by the descendants of the Sebastian family. SEI owns three other companies: Foresthill Telephone Company (FTC), a regulated telecommunications carrier that receives CHCF-A subsidies; Kertel, which provides information services and construction services to Kerman; and Audeamus, which provides broadband services in Kerman's service area.

Kerman does business under the name Sebastian. FTC, Kertel, and Audeamus also do business under the name Sebastian. SEI, Kerman, FTC, Kertel and Audeamus share many of their resources and facilities, such as the Central Office Building in Kerman, California, the adjoining warehouse; the work yard, vehicles, employees, and other facilities. The Central Office Building in the City of Kerman is branded with the name Sebastian on the exterior, as is Sebastian's

[22] Exhibit KTC-1 at 3.

other office building in the City of Fresno. The affiliates do not maintain separate offices from Kerman.

Kerman's last GRC was filed by Advice Letter and was resolved in Resolution T- 17081 for a test year of 2008.

Kerman anticipates investing approximately $5,300,000 in Kerman for plant upgrades during the years 2015 and 2016 collectively. Kerman asserts that this level of investment will provide a reasonable investment amount given the need to upgrade to a fiber platform over time. The fiber platform is necessary to meet the projected demand of broadband customers (500 megabits per second (Mbps) within the next 10-15 years) and the expected directives of state and federal legislators and regulators. Kerman plans to invest in facilities that will be capable of delivering the services that customers will want in the years and decades to come.[23]

Mr. Barcus states that "customer demand for basic services like voice is flat or declining, while demand for advanced services, especially broadband, continues to increase."[24] According to Kerman, the FCC is continuing to work on and develop rule changes that reflect this since the release of its *Universal Service Fund/Intercarrier Compensation Transformation Order* (FCC 11-161) and *Further Notice of Proposed Rulemaking*. Kerman further states that "the state Legislature has concluded that investments in broadband capable services be incorporated into the rate base for small telephone companies."[25]

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[23] Exhibit KTC-4 at 3-9.

[24] Exhibit KTC-1 at 7.

[25] *Id*.

Many Small LEC service areas, such as the area served by Kerman, are already served by wireless and cable companies (some of whom are affiliates of the Small LECs, like Kerman's affiliate Audeamus). The service territories are not open to wireline competition, so Kerman is both the carrier of last resort and the monopoly carrier. Normally, as a monopoly carrier Kerman would have an incentive to raise its rates for services, however, with access to the CHCF-A, Kerman does not have that incentive, in fact, as it argues in this case, it appears to have the opposite incentive, to keep rates low. Keeping rates low does not negatively impact Kerman due to the availability of the CHCF-A subsidy.

On December 19, 2014, the Commission issued D.14-12-084 resolving Phase 1 of R.11-11-007, the CHCF-A rulemaking. D.14-12-084 determined that the Small LEC's Basic Residential Service Rates "must be in a range of $30, inclusive of additional charges, to $37, inclusive of additional charges," but also finds that "[a]ctual rates will be set in the individual General Rate Cases of the Small Incumbent Local Exchange Carriers."[26] The Phase 1 Decision also found that the "Small Incumbent Local Exchange Carriers which received funds from the California High Cost Fund-A must adhere to the Federal Communications Commission's (FCC's) standards for corporate expense limits in their General Rate Cases," but the results of the corporate expense cap may be rebutted in individual company rate cases.[27]

On January 30, 2015, Kerman updated its rate request in response to D.14-12-084 in R.11-11-007. Kerman revised its revenue requirement and

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[26] D.14-12-084 at Ordering Paragraph 9.

[27] *Id.* at Ordering Paragraphs 2 and 3.

expense estimates, forecasting intrastate revenue requirements of $10,274,968 for test year 2016, a 28% increase over the past five-year average. Kerman proposed an increased CHCF-A subsidy amount of $6,011,945, a $2,472,220 increase over its current subsidy. The request is 70% greater than the 2016 authorized support.[28]

Kerman proposes a local residential service rate be adopted that is $30.00, inclusive of the local service rate, Extended Area Service Charges (EAS) charges, federal subscriber line charges (SLC), Access Recovery Charge (ARC), and miscellaneous public program surcharges. Kerman proposes that the tariffed basic rate to be adopted should be calculated by starting with $30.00 and subtracting out the additional charges to reach the reasonable basic rate.[29]

Kerman also addresses the impact of the FCC's corporate expense cap. Kerman proposes adjustments to the results of the cap calculation and provides arguments to rebut the presumption that amounts above the cap are unreasonable.

According to Kerman, the Supplemental Testimony "only modifies and supplements the November 3, 2014 testimony of David Clark (Exhibit KTC-7(b)) related to the local service rate and the corporate expense adjustments. "All other aspects of my original testimony remain as presented in the November 3, 2014 update."[30] Kerman initially requested an intrastate revenue requirement of

[28] Resolution T-17505, adopted $3,539,725 in CHCF-A funding for Kerman for calendar year 2016.

[29] Exhibit KTC-10 at 3.

[30] Exhibit KTC-10 at 3.

$11,000,111 and an associated CHCF-A draw of $6,804,638.[31] Kerman calculated the expense portion of the requested revenue requirement using eight months of unaudited financials for 2014 and annualizing the partial year expenses and adjusting them by a 2% and 2.4 % inflation factor, and utilized company proposed investment projections to calculate the revenue requirement for 2016.[32]

Kerman's request was then updated in its rebuttal testimony of April 16, 2015. Kerman revised its 2016 revenue requirement calculation to $10,442,787 based on the final, audited "end of year" financials, including $7,474,394 in projected operating expenses, a $1,779,871 return on rate base, $1,188,521 in estimated tax liabilities and a CHCF-A draw of $6,044,785.[33]

Kerman notes that its proposed $1,779,871 return on rate base is calculated by multiplying its proposed rate base of $12,953,938, by its proposed rate of return of 13.74%. Kerman maintains that, with the exception of "Other Work Equipment," ORA does not dispute its proposed rate base, and that, "at a minimum, the Commission should follow the consensus of the parties on this issue and accept Kerman's rate base proposal of $12,509,966 as to everything but "Other Work Equipment."[34] Kerman also proposed a five-year plan including $5,271,400 in plant additions. Kerman notes that ORA does not object to

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31 Exhibit KTC-1 at 9.

32 Kerman Opening Brief at 26.

33 Although ORA does not object to Kerman's updating its request in its rebuttal testimony to reflect updated financials, to avoid a never-ending cycle of updating information, we do not adopt this process as a policy or precedent.

34 Kerman Opening Brief at 28.

Kerman's plant recommendation and therefore the Commission should adopt Kerman's $5,271,400 plant additions figure for 2015/2016.[35]

Kerman notes that in its last rate case, which was resolved by Commission Resolution T-17801, the Commission required Kerman to evaluate Local Measured Service (LMS) options as part of its next rate case. Kerman's application does not address local measured service options as requested. Instead, Kerman states that it does not support implementation of LMS and has not had any requests from customers for a measured service offering. Kerman notes that in its 2003 rate case – before the LMS directive from the Commission – customers voiced opposition. Kerman states that LMS runs "counter to industry usage and would impose implementation costs and investment requirements that are not justified by any customer benefits."[36]

Kerman also notes that the FCC has adopted a local service rate floor, and the adoption of LMS would put Kerman below the price floor for any LMS offerings, thereby reducing federal support for Kerman's intrastate revenue requirement, and would be counterproductive to both the company and ratepayers who would be responsible for a larger portion of Kerman's revenue requirement that could have been fulfilled through federal funding.[37]

Kerman takes issue with ORA's criticism of its operations and argues that ORA should support Kerman "instead of focusing so closely on Kerman's

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[35] Kerman Opening Brief at 30.

[36] Exhibit KTC-1 at 9.

[37] *Id*.

CHCF-A draw so that AT&T's customer and wireless customers statewide can save a few pennies"[38]

6. ORA's Position

ORA recommends that the Commission authorize intrastate revenue requirements totaling $6,602,548 for the 2016 test year. When combined with its forecast of other revenues, ORA calculates a total CHCF-A subsidy of $1,938,638 from the CHCF-A in test year 2016.[39]

ORA also makes nine recommendations to separate Kerman's operations from its parent company and its affiliates by requiring Kerman and its affiliates to do the following:

- Be held in separate legal entities.
- Maintain separate books for all transactions.
- Maintain separate bank accounts for all transactions.
- Have no joint advertising or marketing.
- Have no overlapping of employees or responsibilities.
- Have no joint events, sponsorships, fundraisers, or charitable donations.
- Not transfer any physical assets without first obtaining the necessary approvals from the Commission.
- Conduct financial transactions with each other at "arms-length."

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[38] Exhibit KTC-2 at 3.

[39] Exhibit ORA-1 at 1. This amount was later reduced to $1,905,695 in ORA's subsequent March 27, 2015 report and recommendation

- Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to Kerman from unaffiliated third parties for similar transactions.[40]

We discuss ORA's proposal, along with Kerman's opposition, *infra*, at Section 14 of this decision.

7. Cost of Capital/Rate of Return

"The legal standard for setting the fair rate of return has been established by the United States Supreme Court in the *Bluefield* and *Hope* cases.[41] The Bluefield decision states that a public utility is entitled to earn a return upon the value of its property employed for the convenience of the public, and sets forth parameters to assess a reasonable return. Such return should generally be equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings attended by corresponding risks and uncertainties. That return should also be reasonably sufficient to ensure confidence in the financial soundness of the utility, and adequate, under efficient management, to maintain and support its credit and to enable it to raise the money necessary for the proper discharge of its public duties." (D.09-05-019 at 13-41.)

ORA notes that Kerman's requested 13.63% cost of capital is substantially higher than the 10% authorized in recent years, and is counter to all reasonable analysis of market changes that have occurred since 1997 when the Commission

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[41] *Federal Power Commission v. Hope Natural Gas Company* (1944) 320 U.S. 51, and *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia* (1923) 262 U.S. 679.

adopted 10% as the weighted average cost of capital for the small telephone companies.[42]

Calculating the cost of capital involves consideration of three components; capital structure (debt to equity ratio), cost of debt, and cost of equity. Each component affects the final cost of capital percentage, which is then applied to the utility's ratebase. The result is incorporated into the revenue requirement that determines the rates customers pay for utility services.

A comparison of Kerman's proposed and ORA's recommended positions on the components of return on equity are shown in Table 1.

Table 1

	Kerman Proposed	**ORA Recommended**
Risk-Free Rate	4.47%	2.91%
Equity Risk Prem.	6.96%	5.88%
Indust. Risk Prem.	-1.18%	0
Size Premium	5.99%	0
Total of Equity Components	**16.24%**	**8.79%**

A comparison of Kerman's proposed and ORA's recommended cost of capital, is shown in Table 2.

[42] ORA Opening Brief at 56.

Table 2

	Kerman Proposed	**ORA Recommended**
Debt	20%	60%
Equity	80%	40%
Cost of Debt	3.2%	3.2%
Return on Equity*	16.24%	8.79%
Total Cost of Capital	**13.63%**	**5.44%****

* These numbers are based on the results of the return on equity calculations illustrated in Table 1.
** ORA's recommended cost of capital increased to 5.71% as a result of its March 27, 2015 report and recommendation update, and is reflected in Results of Operations line item changes in Appendix A.

Conclusion

We adopt neither Kerman's nor ORA's recommended cost of capital calculations. A.11-12-011 was opened in 2011 and a final decision was anticipated in early 2013. However, a stay, an extension of the stay and other procedural matters resulted in A.11-12-011 overlapping with the initiation of A.15-09-005, the Commission's ongoing cost of capital proceeding for the Small Local Exchange Carriers,[43] including Kerman. A decision in A.15-09-005 is expected later this year. Therefore, the Commission declines to adopt a new cost of capital for Kerman in this proceeding. As a result, until a decision in A.15-09-005 is issued, Kerman's cost of capital will remain at 10%.Once a decision in A.15-090005 is issued, Kerman shall submit a Tier III advice letter to

[43] Calaveras Telephone Company (U1004C), Cal-Ore Telephone Co. (U1006C), Ducor Telephone Company (U1007C), Foresthill Telephone Company (U1009C), Kerman Telephone Co. (U1012C), Pinnacles Telephone Co. (U1013C), The Ponderosa Telephone Co. (U1014C), Sierra Telephone Company, Inc. (U1016C), The Siskiyou Telephone Company (U1017C), Volcano Telephone Company (U1019C),

implement new ROR and resulting revenue requirement and CHCF-A support changes.

8. Corporate Expense Cap

In D.14-12-084 the Commission determined that it was necessary to adopt a uniform standard for determining a reasonable level of corporate expenses for carriers that receive subsidies from the CHCF-A program. Adopting a uniform standard "allows the program to achieve its goals while ensuring that the level of support is not excessive or wildly disparate across companies, and avoids imposing an undue burden on California ratepayers who contribute to the fund."[44]

The Commission wrote, "Small Incumbent Local Exchange Carriers which receive funds from the California High Cost Fund-A must adhere to the Federal Communications Commission's standards for corporate expense limits in their General Rate Cases."[45] The Commission also found that adopting and applying the FCC Corporate Expense Caps will "cap the amount of corporate expenditures that can be recovered from the CHCF-A program," and "create incentives to align expenditures with the cap to reduce rate case litigation costs."[46]

The Commission also found that applying the FCC Corporate Expense Cap will not limit the amount of a company's corporate expenditures, but will limit the amount of corporate expenditures that can be recovered from the

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[44] D.14-12-084 at 28.

[45] D.14-12-084 at 86.

[46] D.14-12-084 at 29.

CHCF-A program. D.14-12-084 determined that there is a "rebuttable presumption" that any amount above the FCC's Corporate Expense Cap is unreasonable.[47] Carriers have the opportunity to demonstrate that a different level of corporate expenses is reasonable.[48] The FCC used state averages in its calculation of the national corporate expense cap formulas, therefore some states are below California and some are above.

Effective January 1, 2012, the FCC in FCC 11-161232 modified the limitation on corporate expenses using the following formulas:

- For Study areas with 6,000 or fewer total working loops the monthly amount per loop shall be –
  - $42.337 - (.00328 x number of total working loops), or
  - $63,000 / number of total working loops, whichever is greater.
- For study areas with more than 6,000, but fewer than 17,887 total working loops, the monthly amount per loop shall be –
  - $30.07 + (117,990/number of total working loops); and
- For study areas with 17,887 or more total working loops, the monthly amount per loop shall be $9.56.[49]

8.1. Kerman's Estimated Corporate Expenses

Kerman calculates that application of the FCC Corporate Expense Cap without any modification results in a cap on Kerman's corporate expenses of $1,692,783 ($1,537,917 allowable corporate expenses plus $154,865 CPI growth

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47 *Id.*

48 D.14-12-084 at Ordering Paragraph 3.

49 FCC Report And Order And Further Notice of Proposed Rulemaking, FCC 11-161, rel. November 18, 2011, 232.

allowance).[50] Kerman states that it has 4,848 loops. In its Direct Testimony, Kerman's request for corporate expenses totaled $3,365,417 (after excluding $175,603 in legal expenses related to the general rate case).

In Rebuttal Testimony, Kerman's proposed corporate expenses totaled $1,559,228.[51] Kerman arrived at this figure by applying intrastate allocation factors to its total corporate expense amount of $2,269,950. Kerman goes on to state that the corporate expense adopted should at least be the $1,544,761 calculated in its rebuttal testimony.

Kerman's objection to the strict application of the Corporate Expense Cap is based on three factors that Kerman argues make its corporate expenses justifiably higher than the proxy group used to create the cap;

- Application of the corporate expenses cap seriously compromises its ability to perform necessary functions and continue to operate in an efficient and reliable manner;[52]
- Higher wages that Kerman must pay to its corporate employees in California relative [to] companies in other states where labor is less expensive; and,
- The added regulatory costs of operating in California, which has far more extensive regulatory burdens than most states."[53]

Kerman recommends adjustments for wages and regulatory intensity for its corporate expense estimate. Kerman argues that with these adjustments the

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50 Exhibit KTC-8, att. DC 011, "Calculation of Corporate Expense Limitation."

51 Exhibit KTC-11.

52 Exhibit KTC-10 at 18.

53 Kerman Opening Brief at 18.

Commission should adopt an adjusted intrastate expense cap of $1,559,228 which it states is $595,273 lower than Kerman's actual intrastate corporate expenses.[54]

Kerman argues that it is located in a high cost area in general, which makes the cap unreasonable as applied to Kerman.[55] To support this argument Kerman presents evidence from the U.S. Bureau of Labor Statistics to demonstrate that the Kerman area has high labor costs.[56] According to Kerman, the area's average corporate wage is $76,548 and the average California corporate wage is $93,956.[57]

Kerman also claims that the number of regulatory proceedings is higher in California at ten per year than other states at four per year and provides a calculation to increase its corporate expenses to allow for this additional expense.

8.2. ORA's Analysis of Kerman's Corporate Expenses

ORA argues that Kerman has failed to address specific corporate expenses and explain how those expenses are reasonable. ORA states that it analyzed only 3% of Kerman's 2014 expense transactions and identified areas where corporate expenses could be reduced.

8.2.1. Executive Benefits and Bonuses

ORA states that Kerman's corporate wages are above both the Kerman-area and California averages ($76,548 and $93,956 respectively), noting that Kerman's IS manager earns $138,480 and Kerman's president earns $236,202

[54] *Id.* at 58.

[55] Exhibit KTC-22 at 19.

[56] *Id.*

[57] *Id.* at 23.

per year. ORA also asserts that Kerman's testimony is contradictory when it states that Kerman is a low-income area and its residents cannot afford rate increases, while at the same time arguing that it is a high-cost labor area.

ORA notes that it required a series of requests, and correction of several errors to obtain an accurate figure for Kerman's total executive compensation.[58] ORA was eventually informed that Kerman's total actual 2014 corporate compensation expenses totaled $1,681,509.86 including benefits and bonuses. However, ORA subsequently identified, and Kerman confirmed, that this amount does not include additional compensation of $294,705 paid to Kerman's executives. This figure includes amounts that Kerman paid in bonuses for board meeting fees and a quarterly retainer, which combined, totals $294,705, as shown in the Table 3 below.

Table 3

Description	Adjustment
Executive Bonuses	$200,000
Board Meeting Distribution	30,705
Quarterly Retainer	64,000
Total Additional Executive Compensation	**$294,705**

The additional executive benefits and bonuses bring Kerman's total 2014 executive compensation to $1,976,214.86

ORA maintains that Kerman has not shown that these amounts are reasonable or necessary to retain employees. For example, ORA points out that Kerman's president, William Barcus, is also a shareholder and therefore it is not

58 Exhibit ORA-1 at 28.

apparent why Kerman must pay a bonus to retain him. ORA adds that most of the board members are family members who own a portion of the company and thus have an incentive to actively participate and would likely do so without remuneration.

ORA asserts that since these amounts are not reasonable and prudent expenditures, they reflect rate making adjustments that would allow Kerman to more easily meet the FCC's corporate expense cap.[59]

The Commission adopts ORA's recommendation. Kerman's additional $294,705 in executive compensation is not warranted and is therefore unreasonable as a justification to exceed the corporate expense cap.

8.2.2. Terminated Temporary Executive Position

ORA recommends that $58,144 be removed from Kerman's 2016 corporate expenses estimate. ORA asserts the amount represents the salary of a temporary executive position filled in May 2013 and terminated in May 2014. ORA suggests that Kerman's corporate expenses be reduced by $58,144, to more easily meet the corporate expense cap.

The Commission agrees that including temporary executive compensation in corporate expenses for a position that no longer exists is unreasonable. Therefore we adopt ORA's recommendation and disallow the corporate expense of $58,144.

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[59] Exhibit ORA-1 at 29.

8.2.3. Salary and Benefits for New Information Services (IS) Manager

Kerman is in the process of hiring a new IS manager to replace the one that retired at the end of 2014. Kerman projected the new IS manager's salary at $138,480, the level of compensation of the previous manager at the time of retirement. ORA states that it is unreasonable for Kerman to project the total salary and benefits of a new IS manager using the retired manager's final salary. ORA suggests that Kerman use an average of the retired IS manager's total salary and benefits from 2010 to 2014, with annual escalations, to project the new IS manager's salary of $99,516 for 2016.[60] On that basis, ORA suggests that Kerman's forecast of corporate expenses could be reduced by $38,964, the difference between Kerman's original forecast and ORA's recommended salary, to more easily meet the FCC corporate expense Cap.

Kerman asserts that ORA's recommendation ignores the wage premium that Kerman must pay to operate in California. Kerman also states that the reasonableness of Kerman's IS manager's salary cannot be judged by an overall average that includes wages for entirely different positions.

The Commission finds that Kerman paying the new IS manager the same as the retiring IS manager is unjustified and therefore unreasonable. Kerman could more easily meet the corporate expense cap if its salaries were more in line with the Kerman and California averages it cites. On that basis Kerman's projected operating expenses are reduced by $38,964. This is not a prohibition on Kerman actually paying its new IS manager $138,480, however, Kerman's

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[60] Exhibit ORA-1 at 30.

justification for this salary is insufficient to warrant an adjustment to the corporate expense cap.

8.2.4. Payments for Affiliate Memberships in Industry Groups

According to ORA, Kerman pays the membership fees in a broadband industry group called Calcom for Kerman's parent company Sebastian. ORA states that according to Calcom's website, its mission is to accelerate broadband deployment. ORA points out that Kerman does not deploy broadband. ORA also points out that Kerman has not demonstrated why it, rather than its broadband affiliates, Audeamus or Sebastian, pay the membership fees.

Kerman paying Calcom membership fees of $14,857, which do nothing to enhance service to Kerman's customers, is unreasonable. Therefore, the $14,857 of fees will be disallowed, making it easier for Kerman to meet the corporate expense cap.

8.2.5. Charitable Donations, Contributions and Sponsorships

According to ORA, Kerman included in proposed rates the corporate expenses incurred to promote Sebastian's image in the community through donations, sponsorships, and contributions, including contributions to political action organizations. ORA maintains that Kerman could save $241,465 by eliminating donations, contributions, and corporate sponsorships that are intended solely to enhance the "brand image of Sebastian." For example, ORA explains that state subsidies are currently used by Kerman for the funding of Fresno State Bulldog sporting events, a polo festival in Sebastian's name, the

Kerman Christian School, a golf tournament, catering for a Fresno State tailgate party, and the California Independent Telephone Political Action Committee.[61]

ORA notes that the Commission has previously found that donations, contributions, and sponsorships are not typically paid for by ratepayers of regulated utilities, because these expense do little to increase safety and reliability of the services provided.[62] ORA further notes that because these donations and sponsorships are done in the name of Sebastian, which includes Kerman's parent company and affiliates, any benefit to Kerman is limited.

Table 4 lists the 2014 Donations, Dues, and Sponsorships charged to Kerman.

Table 4

Description	Amount
Sebastian Image	$123,903
Sponsorships	70,993
Donation/Contribution	46,569
Total	**$241,465**

In D.86-01-026, the Commission stated, "Staff identifies $13,000 as PacBell's share of Bellcore's dues, donations and contributions for test year 1986. It naturally recommends disallowing this expense consistent with our

[61] See, Attachments 2-4, 2-6 and 2-7 to Exhibit ORA-1, Kerman's supporting documentation to ORA Data Request C3002 and e-mail confirmation, including invoices, for the Bulldog Sports Properties ($70,560 annual cost), Sierra Foundation (2013 Polo Fest) ($10,000), Golf tournament (several invoices totaling $5,100), Fresno State Tailgate ($16,830 allocated to Kerman), California Independent Telephone Political Action Committee ($6,800), Kerman Quarterback Club, The First Tee of Fresno ($1,200).

[62] 62 Cal. 2nd 634.

long-standing rationale that ratepayers should not fund discretionary contributions to organizations when they have no voice in selecting the recipients. We will adopt this adjustment."[63]

Consistent with D.86-01-026 we adopt ORA's suggested reduction of $241,465 to corporate expenses for donations, dues, and sponsorships for ratemaking purposes. These expenses are not reasonable as ratepayers have no voice in selecting the recipients and these activities do not increase safety and reliability for Kerman's customers. The elimination of these expenses will allow Kerman to more easily meet its corporate expense cap.

8.2.6. Employee Parties and Retreats

ORA notes that Kerman also bears a significant portion of the costs of several parties and retreats arranged by Sebastian for the employees of SEI, Kerman and the other affiliates, Foresthill, Audeamus, and Kertel. According to ORA, Kerman pays 75% of the costs of a holiday party, 45% of the costs of the holiday retreat and 40% of the annual banquet. ORA notes that for Kerman's 69 employees, 80% of which work part time for Kerman, the expense of $33,863 for a holiday party equates to a cost of $491 per employee, paid for by California ratepayers.[64]

Table 5

Description	**Total 2014 Cost**	**Total Charged to Kerman**	**% Cost to Kerman**
Holiday Party	$43,130	$33,863	79%
Annual Retreat	9,635	4,307	45%

[63] D.86-01-026 at 285.

[64] Exhibit ORA-1 at 33.

Annual Banquet	44,060	17,546	40%
Total	**$96,855**	**$55,716**	**58%**

Table 5 shows Kerman corporate expenses of $55,716 for party, retreat and banquet costs are not reasonable. We agree with ORA that California ratepayers should not be subsidizing parties and retreats and disallow $55,716 in corporate expenses related to these events.

8.2.7. Corporate Education and Planning Expenses

ORA explains that Kerman's total corporate expense also include the costs of corporate education and planning. ORA states that it selected a sample of Kerman's recorded education and planning expenses to test for reasonableness and found that the expenses identified far exceed the lodging and per diem rates authorized by the State of California. ORA maintains that because Kerman draws from the CHCF-A to subsidize its revenues and expenses, Kerman's business travel expenses included in rates should be made in accordance with the state's lodging and per diem rates.[65]

We view ORA's recommendation as reasonable and limit Kerman's business travel expenses to the state's lodging and per diem rates for corporate expense ratemaking purposes.

8.2.8. Corporate Rental Apartment

Kerman maintains a corporate rental apartment and records one-half of the rental apartment expense as a corporate expense. Initially Kerman stated that the apartment was used to host business visitors. However, in its Opening

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[65] Exhibit ORA-1 at 34.

Brief, Kerman stated that employees who live in or near Foresthill must often travel to Kerman on business, therefore the use of the apartment saves money because otherwise its employees would have to rent a hotel room.

Kerman explains that it pays $1,175 per month for the apartment, $403 of which is assigned to intrastate non-corporate expenses. Kerman maintains that even assuming the lowest recommended per-night hotel stays for Commission employees of $105 per night, it would take just over 11 nights per month of hotel stays to exceed the cost of the apartment.[66]

ORA objects to including the cost of the apartment in the corporate expenses as Kerman did not offer an explanation for hosting business visitors or how hosting these visitors might enhance Kerman's ability to provide safe and reliable service. ORA also states that Kerman has not provided any documentation to support the business use of the apartment. For example, ORA claims that Kerman has not provided information regarding which employee or employees used the apartment for what assignment and period of time. ORA asserts that Kerman has not demonstrated why any business visitors who might use the apartment should have their business expenses subsidized by the CHCF-A.

ORA notes that in its last GRC, Kerman's request for apartment rental expense was also denied as unreasonable.

In order to overcome a presumption that expenses above the FCC's corporate expense cap are unreasonable, Kerman must make a showing that the corporate apartment is reasonable. Kerman did not demonstrate why the

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[66] Kerman Opening Brief at 51.

apartment rent should be borne by the ratepayers and it is therefore not reasonable. We continue to disallow the total rent expense of $7,050, whether categorized as a corporate or operational expense, for ratemaking purposes.

8.2.9. Kertel Maintenance Contract

Kerman states that its affiliate Kertel provides network service to Kerman, in the amount of $793,100 per year.[67] According to Kerman, Kertel provides Network Operating Center and Information Technology Technician labor to support Kerman's operations and customers. For this service, SEI bills Kerman $66,091.67 per month. Of this amount, $8,081.25 per month ($96,975 per year) is allocated to Kerman's total corporate expenses.[68] The remaining $58,010.42 per month is allocated to other operating expenses of Kerman.

ORA explains that Kerman could not provide a copy of the contract between Kerman and Kertel, nor could it provide any detailed invoices.[69] ORA explains that Kerman only provided an invoice for $66,091.67 to support its position. The invoice, included as Attachment 2-10 to Exhibit ORA-1, does not describe the specific services provided to Kerman and does not identify any labor or materials. Without more information regarding the terms and conditions of the contract, ORA cannot review the contract for reasonableness.

Without documentation providing details of the maintenance contract with Kertel, Kerman's requested $96,975 per year for such services is unreasonable and does not justify exceeding the corporate expense cap.

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[67] ORA Report at 36.

[68] Exhibit ORA-1 at Attachment 2-10.

[69] ORA Opening Brief at 32.

8.2.10. Litigation Expenses

Kerman projected its legal expenses for 2015 to be $525,475, approximately 4% of its operating expenses and argues that the rate case costs in the amount of $175,603 should be considered outside of the corporate expense cap.

ORA counters that Kerman's projected legal expenses for 2016 of $525,475 are included in the $3,365,417 that Kerman argues would be unreasonable to reduce by 50% if the corporate expense cap were applied.

ORA states that Kerman did not provide any supporting documentation for this amount, claiming that information documenting its legal expenses is protected by "attorney-client privilege." Without the ability to verify the reasonableness of the costs, ORA is concerned that Kerman has no incentive to control the amount of money it spends on legal services. ORA posits that absent any supporting documentation, it is impossible for the Commission to determine if the legal expenses requested are reasonable or related to the provision of safe and reliable utility service. For example, the year 2015 could have included a number of unusual, or one-time legal expenses that are unlikely to reoccur.

ORA states that although it did not have access to any documentation supporting 2015 legal expenses, it did review a sample of 2014 legal expenses and claims and three invoices totaling $35,095 should not be included for forecasting purposes because those three invoices were for services rendered in 2013, and Kerman uses 2014 expense to project 2016 expenses.

ORA also objects to Kerman's position that the rate case costs of $175,603 should be considered outside of the corporate expense cap. We agree, Kerman's rate case expense should be included within the corporate expense cap.

Kerman has not provided sufficient justification or verification for any legal expenses above the corporate expense cap. If Kerman wants legal expenses to be considered above the corporate expense cap, detailed invoices must be provided. Kerman can submit them as confidential, subject to Public Utilities Code Section 583 and General Order 66-C, as is the case with all other utilities regulated by this Commission.

8.2.11. Regulatory Position

Kerman states that it needs an additional regulatory person at $120,000 per year to assist with the number of proceedings in which Kerman participates. Kerman states that a regulatory employee left at the beginning of 2014 and the regulatory manager's time is currently split between Kerman and FTC.

ORA argues that Kerman's request is not reasonable, because the regulatory manager's time has been split between Kerman and FTC since at least 2010.[70] ORA notes that, in addition to splitting his time between Kerman and FTC, Kerman states that the regulatory manager also spends a portion of his time on SEI's entities other than FTC (e.g., Kertel and Audeamus).[71] ORA also notes that "since the one regulatory manager left the company at the beginning of 2014, Kerman's regulatory manager's total time allocated to Kerman work has not varied significantly despite the fact that in 2014, alone, Kerman "actively participated in several general telecommunications proceedings."[72]

ORA posits that because Kerman's regulatory manager can handle the demands of several Kerman proceedings working only part time, the need for an additional full time regulatory position is not justified. ORA recommends that

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70 Exhibit ORA-1 at 38.

71 *Id* at Attachment 2-15.

72 Exhibit KTC-10 at 28.

the $120,000 in expense requested for the regulatory employee should not be used as a means to justify exceeding the corporate expense cap.

Kerman argues that if the regulatory manager is required to devote full-time to Kerman, it will leave FTC without any regulatory support and that ORA would surely oppose a new regulatory position in FTC's next general rate case.

We agree that it appears another regulatory manager position is unnecessary and therefore unreasonable as justification to exceed the corporate expense cap. However, we leave it to Kerman to use its best judgment regarding hiring decisions, within the limits of the FCC corporate expense cap we adopt here.

Conclusion

Although we agree with ORA's recommended reductions in Kerman's estimated corporate expenses (see table below), in its Rebuttal Testimony, Kerman adjusted its corporate expenses downward significantly to $1,559,288, so much of the $842,971 that ORA recommends be disallowed has been removed by Kerman, as shown in Table 6.

Table 6 - ORA's Recommended Ratemaking Adjustments

Description of Adjustment	Amount
Additional Executive Compensation	$294,705
Terminated Temp. Executive Position	$58,144
Retired Manager Salary Adjustment	$38,964
Calcom Membership	$14,857
Donation/Contribution/Sponsorship	$241,465
Annual Party/Banquet/Retreat	$55,716
Rental Apartment	$7,050

Unsubstantiated Corporate Maintenance Cost	$96,975
2013 Attorney Fees	$35,095
Total Identified Adjustments	**$842,971**

Kerman has not provided sufficient documentation to support an adjustment of corporate expenses above the FCC cap. However, the cap does not limit Kerman's ability to spend above the cap, it merely limits its ability to have those expenditures paid for via the CHCF-A fund.

The Commission sets the corporate expense cap for Kerman at $1,541,031 ($1,530,319 plus the CPI adjustment of $10,712) based on the FCC calculations[73] and an updated loop number of 4,789.[74] The difference between the FCC corporate expense cap of $1,530,319 that we adopt here, and Kerman's updated estimate of $1,559,288 is $18,257. Kerman has not justified any expenses above the FCC calculated corporate expense cap. We are not persuaded by Kerman's argument that the difference between the unmodified cap and Kerman's estimate will cause the "major, customer-affecting issues to arise in Kerman in the long-term and possibly even in the short-term," as alleged in Kerman's Opening Brief.[75]

9. Non-Corporate Expenses

9.1. Central Office Building

Kerman's central office building is located at 811 S. Madera Avenue in Kerman, California. It is owned by SEI and leased to Kerman. Kerman paid rent

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[73] $42.337-(.00328 x 4789) x 12 x 4789.

[74] Exhibit ORA-1 at 7, Footnote 15.

[75] Kerman Opening Brief at 59.

to SEI in the amount of $760,800 per year, or $63,400 per month, in addition to taxes and insurance in 2014 and includes this amount in its non-corporate expense.

Under the terms of the December 1, 1999 lease, provided at hearings, the "base rent" is $592,800.[76] ORA states that Kerman was not able to provide ORA with specific information regarding the taxes and insurance for this leased building, claiming that "insurance premiums on properties leased by KTC are not assessed on an asset by asset basis… rather are assessed collectively for all Kerman's assets. Kerman made a similar claim regarding tax assessments.[77]

ORA maintains that Kerman should provide supporting documentation for taxes and insurance it paid to justify recovering this expense from ratepayers and contributors to the CHCF-A program. ORA notes that in Resolution T-17081, the amount allowed by the Commission for ratemaking purposes was $570,941 per year. Given the lack of documentation to support the increase from $592,800 to $760,800 per year, ORA recommends that rent in the amount of $570,941 is reasonable.[78]

Kerman claims that holding it to the terms of the 2008 lease are unreasonable. Kerman states that the central office building is critical to the provisioning of services to its customers, housing the central office switch in which all end user lines are connected in order to permit local and long distance calls. It contains all the necessary plant network elements, including distribution frames, interoffice facility points and other equipment necessary for Kerman's

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76 Exhibit KTC-38.

77 Exhibit ORA-1 at 41, citing Kerman e-mail dated February 24, 2015.

78 *Id.* at 43.

operations. Kerman posits that given the critical functions of the central office building, its rental expense claim of $760,800 is more than reasonable and that ORA's recommendation ignores even inflationary adjustments.

Kerman argues the necessity and importance of the central office building, a point not in contention. The issue here is whether the rental expense claimed by Kerman for the central office building is reasonable. The only information we have for Kerman's rental expense is the lease amount from Resolution T-17081, from Kerman's last rate case. Kerman provided no documentation to support the rent increase from $570,941 to $760,800. Additionally, Kerman was unable to provide separate figures for taxes and insurance for the central office building, claiming both taxes and insurance are assessed collectively for all its assets and so no individual figures were available.

Absent supporting documentation for the rent increase, insurance and the tax assessment expenses, Kerman's request for $760,800 in rental expense is unreasonable. The Commission adopts $570,941 as the reasonable annual rent expense for the central office building, resulting in a reduction of $189,859 in total non-corporate expense.

9.2. Maintenance Non-Corporate Expense – Kertel

Kerman's unregulated affiliate, Kertel provides Network Operating Center (NOC) and IT (Information Technology) technician labor to support Kerman's operations and customers. A portion of this IT maintenance expense is reported as a corporate expense. SEI bills Kerman for this maintenance service at a price of $66,091.67 per month or $793,100 per year. Of this amount, $58,010 per month or $696,125 per year is allocated to Kerman's total non-corporate expenses.[79]

ORA states that despite numerous requests, Kerman has not produced a copy of a contract with Kertel to provide the services. ORA asserts that as of March 27, 2015, the due date for ORA's opening testimony, Kerman was unable to produce a copy of a contract in order for ORA to determine the scope of the work and resources required to meet Kerman's needs.

ORA asserts that the sole documentation provided by Kerman is a monthly invoice that contains no description of the materials provided, the number of hours worked or the work performed.[80] ORA states that in its rebuttal testimony Kerman provided a general description of the maintenance services provided by Kertel,[81] but Kerman has not provided sufficient documentation or information to justify the expenses.

ORA notes that Kerman also pays for network IT services from Neo Nova Network Services, a company that provides managed IP services for telecommunication companies, municipal organizations and cable companies.[82] Kerman fails to explain why the apparently redundant IT services of Kertel are necessary or reasonable.

ORA is concerned by the fact that Kertel is an affiliate of Kerman, and it appears that the contract was not executed at arms-length in that William Barcus is the president of both companies, and the contract was entered into without

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[79] Exhibit ORA-1 at 43.

[80] *Id*. Att. 2-10.

[81] KTC-12 at 28.

[82] ORA Opening Brief at 37.

anything in writing and no description of the labor, materials, or work to be done.[83] ORA asserts that without sufficient documentation, it is not possible to determine whether the expense for the work performed is reasonable.

ORA recommends that the Commission disallow the $696,125 Kerman identified as expense for maintenance services provided by Kertel.

Kerman states that the services Kertel provides under the IS agreement are critical, as they support the operation of Kerman's switch along with other necessary telephone company functions and are not redundant of the network services provided by Neo Nova.[84] Kerman goes on to state that without the IT services provided by Kertel, Kerman would not be able to complete a single telephone call because no problems with the switch could be repaired and this could threaten 911 connectivity for the entire Kerman area.[85]

Kerman claims that in response to a data request from ORA, it provided specific terms regarding the services Kertel provided well in advance of the due date for ORA's testimony. Kerman asserts this was sufficient information and the agreement between Kerman and Kertel does not have to be in the form of a written contract in order to be valid. Kerman also claims that information including a description of materials, hours worked or work performed is not necessary information for an invoice for fixed-cost services agreements.

The Commission shares ORA's concern about the lack of documentation for these services, the relationship between Kertel and Kerman, and the contract for IT services with Neo Nova Network which may be redundant.

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[83] *Id*.

[84] Exhibit KTC-11 at 21-24.

[85] *Id*.

Kerman has the burden of proof regarding the reasonableness of its estimated expenses. Written documentation of the claimed expense is an essential element of that proof and here it is sorely lacking. The only written documentation of this agreement is one invoice Kerman provided in its rebuttal testimony. Kerman's invoice contained no specific information regarding materials used, services performed or hours worked, claiming that this information is unnecessary.

Given that our purpose here is to review the reasonableness of Kerman's expenses, and since Kerman has the burden of proof, it is in Kerman's best interest to provide as much information as possible to support its expense claim. While we will allow Kerman to recover the $696,125 of non-corporate expense related to its maintenance with Kertel in this proceeding, Kerman is put on notice that future rate cases will require an actual executed contract containing specificity regarding the services to be performed by its affiliate Kertel and the charges for these services. Additionally, Kerman should record all the materials provided, number of hours worked, services performed by Kertel and the charges for the services so that the reasonableness of the contract amount can be verified in future rate cases.

9.3. Kerman's Warehouse Facility – 15061 W. C Street

Kerman leases a warehouse facility located at 15061 W. C Street in Kerman from its affiliated entities, the Barcus Family Partnership and the S&K Moran Partnership. Kerman pays rent in the amount of $17,885.59 to the Barcus Family

Partnership and $17,885.59 to the S&K Moran Family Limited Partnership for a total of $35,771.18 per month or $429,254 per year.[86]

ORA states that Kerman was not able to produce a lease agreement until April 28, 2015, the first day of hearings and the lease had been executed just a few days prior. The base rent in the re-executed lease agreement is $382,577.04 per year, less than the lease expense claimed in Kerman's application.

According to ORA, the square footage of the warehouse is 14,058, which equates to $2.27 per square foot per month under the re-executed lease. For comparison, Sebastian's corporate building leases office space in Fresno for $1.95 per square foot per month.

ORA identified comparable warehouse spaces for $0.31 per square foot per month, $0.75 per square foot per month, and $0.50 per square foot per month. Based on this information, ORA maintains that the lease is far above market value, was negotiated between William Barcus and his mother Ruth Barcus, and was therefore not an arms-length transaction.

Kerman states that it was unable to find the original executed lease and so re-executed a lease. Kerman also states that ORA's comparison rents are invalid because they are not in the same area as the existing warehouse, and ORA does not state whether the comparable spaces are specially equipped with adequate facilities to operate a telephone company.

Because Kerman was unable to provide an original executed lease agreement, the monthly rent paid appears to be well above market rate and the

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[86] Exhibit ORA-1 at 45.

recently re-executed lease was between William Barcus and Ruth Barcus, ORA recommends that Kerman's entire lease amount be disallowed.

As an alternative, ORA suggests that the Commission could allow a portion of the lease. According to ORA, base rent is listed in the re-executed lease is $382.577.04.[87]

Again, Kerman has the burden of proof here. It is not up to ORA to prove that Kerman's estimated expenses are unreasonable, but up to Kerman to prove they are reasonable. Kerman's request for non-corporate warehouse lease expense of $382,577.04[88] is unsupported by anything other than a recent, hastily re-executed lease. There is nothing in the record to support Kerman's original claim of $429,254 for the lease expense because apparently neither the lessee nor the lessor is in possession of a copy of the original lease. In addition, even the hastily executed contract appears to provide for an above-market rental rate and is between family members involved in affiliated entities. For these reasons the Commission finds Kerman's requests for $429,254, or $382,577.04 in warehouse rental expense unreasonable and disallows this expense. But since Kerman has spent considerable time in its comments challenging the Commission's conclusion, we believe it will be helpful to address the additional arguments Kerman has put forth in its comments.

Kerman advances six arguments why the decision's disallowance of the lease payments for the warehouse/central office annex is an unlawful departure from the record. First, Kerman argues that the space is essential to its operations,

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[87] Exhibit ORA-1 at 36.

[88] Kerman's original request was for $429,254.

a fact that ORA apparently does not dispute. (Kerman's Opening Brief at 8-9.) Second, Kerman claims that the rental expense is being incurred on a monthly basis in exactly the amounts that Kerman identified, and that the Commission acknowledged the building's necessity in Res. T-17081, 16-17. Third, the basis for the rental expense is memorialized in a contract "which sets forth the ongoing obligations to which the parties must adhere. Ex. ORA-7 (Office Lease)." Kerman notes that the Commission relied on this lease in approving Kerman's rental expense in the 2008 rate case. Fourth, Kerman asserts that it would have difficulty finding a replacement space that could accommodate the same functions. (Ex. KTC-11, at 30:22-27; RT. at 349:7-21.) Fifth, a contract is not invalid just because the parties are unable to find a signed copy, and Kerman cites to *Dart Indus., Inc. v. Commercial Union Ins. Co.* (2002) 28 Cal.4th 1059, 1073. In fact, Kerman asserts that parties may execute leases with past effective dates, citing *Du Frene v. Kaiser Steel Corp.* (1964) 231 Cal.App.2d 452, 458 ("parties to a contract may retroactively adopt prior acts or fix retroactive dates"). Sixth, Kerman claims that is no reason to question the legitimacy of the lease because the signatories to the contract are family members, citing to *Fowler v. Sec.-First Nat. Bank of Los Angeles* (1956) 146 Cal.App.2d 37, 46. We address each of these arguments in order and explain why individually or collectively, they are factually and legally insufficient to warrant the recovery of the rental expense through the rate base.

First, it is immaterial to the Commission's decision that ORA allegedly does not dispute that the warehouse may be essential to Kerman's operations. While the Commission can and does take the opinions of staff into account when evaluating the merits of a proceeding before the Commission, It is the Commission's duty, as part of its legislative function, to determine if proposed rates are just and reasonable. As such, staff cannot bind the Commission through opinions or concessions. (*See Moores v. PGE* (1992) 43 Cal.P.U.C.2d 629, D.92-04-022, Cal. PUC LEXIS 345, at pages *18-19 ["We are of the opinion that the prior determination of the Commission staff is not binding on this Commission simply because it was a staff determination and not a Commission determination."]; and *Universal Marine Corporation v. San Pedro Marin* (1979) I Cal. P.U.C.2d 404, Decision 90334 at 17 ["While advice given by the staff to the public is intended to be helpful, it does not bind the Commission, nor can it be considered as Commission action or policy since the Commission can only act as a body and in a formal manner." This is so regardless of whether the opinion was expressed by a Commission witness. Until such time the opinion is formally adopted by the Commission through a decision or resolution, the opinion cannot bind the Commission.

Second, that fact that an expense was approved previously does not prevent the Commission from reviewing that expense again in a future GRC. In fact, Res. T-17081, the very Resolution that Kerman relies, makes this point clear that Res. T-17081 does not carry precedential effect: "Commission approval is based on the specifics of this Advice Letter and does not establish a precedent for the contents of any future filings by small ILECs." (Paragraph 14 at 21.) Each GRC is a new proceeding requiring both the applicant and the Commission to take a new look at the requested rate relief to determine if there is a sufficient factual and legal showing for its approval.

Third, the fact that a lease for the warehouse may have been executed in 2007 does not establish that there was a validly executed lease agreement for the time and test year covered by this proceeding. We find Kerman's argument troubling since, on the one hand, Kerman claims that the contract sets forth "ongoing obligations," yet, on the other hand, deemed it necessary to have the parties to the contract execute the contract again. If the obligations were in fact ongoing, why was it necessary to affix the parties signatures on a document on April 14, April 20, and April 23, 2015, days before the start of the Evidentiary Hearings? The best evidence for the Commission to determine if the contractual obligations were ongoing, particularly the monthly rental terms, would be the actual current contract, rather than a contract from 2007 that has signatures from April of 2015. To rely on the terms and conditions of a contract executed from 2007 to determine costs that should be made part of the rate base would be contrary to the Commission's duty to determine the merits of a GRC based on the record before it in this proceeding.

Fourth, Kerman's difficulty in finding replacement space does not lead to the conclusion that the rental monies paid for the existing space should be borne by ratepayers. Kerman's witness Clark testified that the warehouse is where all the engineers are housed, along with mapping and plant records, as well as materials and supplies used in providing services. (RT at 349:7-21.) But Mr. Clark did not testify that these personnel and documents could not be housed in an alternate location and at a cost less that Kerman claims it is paying in rental expenses to Barcus and S&K Moran. In fact, Mr. Clark testified that if Kerman did not have the current warehouse space, "we would have to find another warehouse somewhere that would do the same function.") There was no mention in Mr. Clark's cited testimony of any difficulty for Kerman to secure an alternate location for the engineers to perform their work and for and for records and supplies to be stored. Even if there was difficulty, that fact does not justify the current rental expenses that Kerman wants to include in its rate base.

Fifth, Kerman's claim that a contract is not invalid because the parties are unable to find a signed copy is not supported by its reliance on *Dart*. What the court was faced with in *Dart* was a matter of contract interpretation when the contract in question has been lost in good faith. In such a situation, *Dart* recognized that "the proponent of the lost document need only prove the relevant substance of the document." (28 Cal.4th at 1073.) Here the Commission is not being asked to interpret a contract in the sense contemplated by *Dart*. Instead, Kerman is asking the Commission to validate the very existence of the warehouse contract and to have ratepayers bear the monthly rental expense. As the Commission is tasked with performing a different function than one of contract interpretation, the standard articulated in *Dart* is inapplicable to this proceeding.

We also do not find that *Du Frene* assists Kerman's cause in saddling ratepayers with the rental costs of the warehouse. It is one thing to retroactively adopt prior acts or fix retroactive dates in order to bind the parties of a contract to certain obligations. It is another thing altogether to then try and take that retroactively-adopted agreement and impose financial obligations on innocent ratepayers, who were not parties to the agreement. Furthermore, Kerman's argument that a lease agreement can be established with a page of signatures executed eight years after the inception of a lease causes the Commission concern that to accept such an argument may require the Commission to run afoul of the statute of frauds, a legal concept that denies the enforcement of certain enumerated classes of contracts unless they are reduced to writing and signed by the party to be charged. (See Civil Code § 1624: contracts "are invalid, unless the same, or some note or memorandum thereof, is in writing and subscribed by the party to be charged or by his agent.") The purpose behind the statute of frauds is to "prevent fraud and perjury with respect to certain agreements by requiring for enforcement the more reliable evidence of some writing signed by the party to be charged." (*Riley v. Bear Creek Planning Committee* (1976) 17 Cal.3d 500, 509; *see also Sterling v. Taylor* (2007) 40 Cal.4th 757, 766 [same].) Courts have interpreted the statute of frauds to apply to a lease of real property for a period longer than one year. (*See* Civil Code § 1624(a)(3); and *Bed, Bath & Beyond of La Jolla v. La Jolla Village Square Venture Partners* (1997) 52 Cal.App.4th 867, 873.) We would expect Kerman to do more than present what appears to be contract that has been cobbled together from different time periods before seeking Commission authorization to pass the rental expenses onto its ratepayers.

Sixth, the Commission may call into question the legitimacy of a lease that has been signed by family. Such a transaction calls into question whether or not the transaction was at arm's length—as California law requires—or whether an affiliate of Kerman is benefiting at the expense of Kerman's ratepayers. In fact, Kerman's cited authority of *Fowler* does not provide Kerman with the legal authority that Kerman would have this Commission believe. The cited quote from *Fowler* states: "Whether these spoken 'plans,' 'understandings,' or 'agreements' are intended by the family members as a binding contract among them is a question of fact for the trial court." (146 Cal.App.2d at 46.) Moreover, what distinguishes *Fowler* even further is that the Court was not dealing with the requirements of affiliate transactions involving regulated entities and unregulated affiliates, where different family members are employed at different companies.

In order for rental expenses to be included in its next general rate case, Kerman should produce a fully executed written lease or rental agreement, including provisions for future rate escalations. Additionally, Kerman should provide no less than three examples of comparable warehouse space for rent to support the reasonableness of the lease amounts with its affiliates the Barcus Family Partnership and the S & K Moran Limited Family Partnership.

9.4. Marketing Expense

Kerman reported total company marketing expenses as of December 31, 2014 of $373,069. ORA notes that Kerman does business under the name Sebastian, along with all of its affiliates. ORA reviewed a sample of Kerman's marketing expense transactions, which showed that some of its marketing expenses are charged 100% to Kerman, while others are allocated between the four affiliated entities doing business as Sebastian, including Kerman, Foresthill, Audeamus, and Kertel. ORA notes that the split between the four entities was not evenly divided to each affiliate. ORA states that most were allocated 66.66% to the regulated entities (33.33% each to Foresthill and Kerman) with the remaining 33.33% split between the unregulated affiliates Audeamus and Kertel.

ORA suggests that the Commission consider whether certain marketing expenses for a regulated carrier for its basic telephone service are necessary or reasonable, because Kerman experiences no competition for basic landline telephone service.[89] Despite Kerman's claims that its marketing expenses were reasonable to "promote [Kerman's] business opportunities, compete against competitors, and make customers aware of services,"[90] ORA found that much of Kerman's marketing is in the form of sponsorships and branding in the name of

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[89] Exhibit ORA-1 at 46.

[90] Kerman Opening Brief at 48.

Sebastian. In addition, ORA notes that some items included in the "marketing" category were actually for hotel stays and restaurant meals.[91]

ORA suggests that while the Commission could find that no advertising or marketing expense is reasonable for a regulated monopoly, at a minimum, ORA argues that a more reasonable allocation of marketing expenses is required.

Kerman states that like any company it incurs legitimate and necessary marketing expenses in order to promote its business opportunities, compete against competitors, make customers aware of services and encourage customer retention. Kerman also asserts that its marketing efforts provide important benefits to its ratepayers and promote consumer education for critical services and safety issues.

Kerman allocated $373,069 to marketing expenses. After reducing the $373,069 by the $42,000 in fees unreasonably paid to Audeamus (discussed below), the remainder is $331,069. ORA recommends that this total be divided equally by the number of affiliates. Although in its Opening Brief Kerman argues that its marketing expenses are actually 28% of the total SEI budget and that a 25% allocation would be incorrect, Kerman does not provide documentation to support or explain why Kerman's allocation is 28%.

While we find that marketing expenses for a monopoly carrier of last resort are not by definition unreasonable, we are troubled by the fact that based on ORA's review of a sample of expenses, the majority of the marketing expenses are borne by the regulated CHCF-A carriers, Kerman and Foresthill, while the affiliates, who would benefit equally or more from any marketing under the

[91] Exhibit ORA-1 at 46.

name “Sebastian” bear lower marketing expenses. We are also troubled by the fact that Kerman has included hotel stays and restaurant meals as marketing expenses, seeing no benefit to its customers in these expenses. The brochures describing services, brochures offering public service information, and white and yellow pages directory fees can reasonably be assumed to benefit Kerman’s customers.

The Commission finds that a regulated monopoly, subsidized by CHCF-A funds, paying a larger, unsubstantiated share of marketing costs than its unregulated affiliates is unreasonable. The Commission removes $248,302 in marketing expenses from Kerman’s total reported non-corporate expenses. The Commission adopts $82,767, which is one fourth of Kerman’s total marketing expense, as reasonable.

9.5. Fees Paid to Audeamus

ORA reports that its review of a subset of Kerman’s expenses revealed that Kerman’s operating expenses include a yearly expense of $42,000 for “customer retention fees.” Kerman pays these fees to its affiliate, Audeamus on a monthly basis and is charged to its marketing expense account.[92] According to ORA, Audeamus sells retail broadband services and charges Kerman a “customer retention fee” for each customer it acquires where the customer also retains telephone service from Kerman. Kerman does not provide a description of how the fees were calculated.

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[92] Exhibit ORA-1 at 47.

Audeamus purchases wholesale access to Kerman's local loop in order to sell retail broadband services to customers in Kerman's service territory.[93] The fees that Kerman charges Audeamus for wholesale access to its network are assessed according to the National Exchange Carrier Association (NECA) Tariff No. 5. The "customer retention fees" that Kerman pay Audeamus are not part of the NECA Tariff.

ORA states that Kerman argues that the fees are paid to compensate for the "added value" associated with the broadband services provided by Audeamus. The fees Kerman pays to Audeamus serve only to offset a portion of the wholesale network access fees paid by Audeamus to Kerman. ORA maintains that these fees are unreasonable.

We agree with ORA, Kerman should be compensated for finding a customer for Audeamus, not the other way around. Therefore, the customer retention fee of $42,000 paid by Kerman to Audeamus is unreasonable and disallowed as an expense.

9.6. Apartment Rental Expense

In Section 9.2.8. we discussed the expense of a corporate apartment, found the expense unreasonable and disallowed $7,050 in corporate expense for the apartment. The same rationale applies here and so we find the non-corporate apartment expense unreasonable and disallow an additional $7,050 for the apartment allocated to customer operations expense.

[93] Exhibit ORA-1 at 39.

10. Non-Discretionary Revenue

10.1. Residential Service Rate

Ordering Paragraph 9 of D.14-12-084 provides as follows:

> The Small Incumbent Local Exchange Carriers' Basic Residential Service Rates must be in a range of $30, inclusive of additional charges, to $37, inclusive of additional charges. This rate range of $30 to $37 will be presumptively reasonable and non-rebuttable. Actual rates will be set in the individual General Rate Cases of the Small Incumbent Local Exchange Carriers.

Kerman recommends the $30 inclusive rate at the lower end of the range. Kerman states that its rates should reflect a total cost of $30 for basic service, inclusive of the SLC, EAS, ARC, and state and federal high-cost and universal service charges.

Kerman maintains that given the low-income demographics of the Kerman service area, the lower end of the range is reasonable. Kerman notes that it had 2,031 lifeline customers at the end of 2014, constituting 52% of its total residential customers. Kerman also notes that the poverty rate in Fresno County is 26% as compared to a statewide rate of 15.9%. According to Kerman, the median income level in Fresno County is $45,563 compared to the median income in the City of Kerman of $49,748 and a statewide median income level of $61,094.[94] Kerman also notes that over 50% of the households in the City of Kerman and almost 54% of the households in Fresno County make less than $50,000 (compared to 41.9% for California as a whole).[95]

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[94] Exhibit KTC-10 at 6.

[95] *Id*. citing United States Census Bureau, available at http://factfinder.census.gov/faces/nav/jsf/pages/index.xhtml (visited January 30, 2015).

Kerman explains that current unemployment rates for Fresno County are in the 10-15% range. Kerman also states that over a quarter of the households in both the City of Kerman and Fresno County fall into the range of $25,000 to $50,000, which is above the Lifeline threshold of $25,000.[96]

Kerman proposes a local service rate of $22.58 for residential service. Kerman also proposes to eliminate the EAS and ARC fees, which are currently included in basic residential rates.

Kerman states that the current elements that would constitute additional or "all inclusive" charges referenced in the FCC's USF/ICC Transformation Order for residential service area for all of the following:

Local Residential Service Rate

Extended Area Service Rate (EAS)

Subscriber Line Charge (SLC)

ARC

Public Purpose Program Surcharges:

- California High-Cost Fund (CHCF)-A
- California High-Cost Fund (CHCF-B)
- Universal Lifeline Telephone Service (ULTS)
- California Teleconnect Fund (CTF)
- Deaf and Disabled Telecommunications Program (DDTP)
- California Advanced Services Fund (CASF)
- 911 Surcharge

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[96] The Income threshold for the California Lifeline program are $25,700, $29,900, and $35,900, for family sizes of 1-2, 3-4, and 4+ respectively, with an additional $6,200 income allotment for each additional family member. (D.14-01-036.)

Kerman states that, to be within the range established in the Phase 1 Decision, Kerman would need to increase its local residential rate to reach the $30 lower end of the range. Kerman therefore proposes a local service rate of $22.58, along with the elimination of the $0.63 charge for EAS service and the $1.50 ARC charge.

If the inclusion of the EAS charge and the ARC charge are not incorporated into the basic local service rate, Kerman maintains that the local service rate should be $20.45. According to Kerman, under either scenario, the local residential rate would be consistent with the lower end of the range established in the Phase 1 Decision.

Kerman states that the proposed rate change in response to D.14-12-084 would result in an increase in local revenues of $102,809 for 2016 over what was provided in the November 3, 2014 update.[97]

ORA agrees with Kerman's proposal to increase basic residential service rates to $22.58, as well as Kerman's proposal to eliminate the EAS and ARC charges for residential customers.[98] ORA agrees that the EAS, which allows customers in Kerman to make a local call to Fresno, is outdated as a result of the FCC's transition away from access/reciprocal compensation to bill-and-keep for terminating minutes.

Kerman also seeks to eliminate the collection of the ARC from customer's bills, and to "neutralize the ARC charge by increasing support for intrastate revenue requirement."[99] According to Kerman, the ARC was established by the

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[97] Exhibit KTC-10 at DC0345.

[98] Exhibit ORA-1 at 10.

[99] *Id.*

FCC's 2011 USF/ICC Transformation Order, and it is required to be applied to the extent that a company's local service rate does not exceed $30. If the local service rate exceeds $30, inclusive of additional charges, the ARC charge cannot be assessed.[100] ORA agrees that the all-inclusive basic residential rate should be raised to $30 to account for eliminating the ARC.

The Commission finds that increasing Kerman's basic residential service rates to $22.58 and eliminating the EAS and ARC charges for residential customers is reasonable. Therefore, the basic residential rate should be raised to $30 inclusive, which will increase Kerman's local revenue for 2016 by $102,809.

10.2. Basic Business Rate

In its direct testimony, Kerman recommended that the basic business service rate should be $30. In its rebuttal testimony, Kerman states that "ORA's proposal to increase business rates in the amount of the EAS increment that I propose to eliminate is sensible."[101] Kerman agrees that "it would be appropriate to increase the basic business service rate to offset the EAS charge currently imposed ($59,312) and roll it into the basic service rate."[102]

ORA recommended that the basic business rate be $36.30, inclusive of additional charges, and eliminating the EAS for business customers.[103] ORA and Kerman agree that increasing the basic business service rate by $4.60, the same

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[100] *Id.* at 30.

[101] KTC-12 at 3.

[102] KTC-12 at DC0345.

[103] ORA Opening Brief at 14.

amount as the EAS that will be eliminated, results in an additional $59,312 in revenue.[104]

However, ORA states that Kerman does not address the shortfall from the lost ARC charges of $1.50 per customer (a revenue loss of $19,341), which accounts for the difference in ORA's recommended revenue adjustment related to business service of $78,653.

ORA and Kerman agree that the total revenue of $59,312 from the discontinued EAS charge for business should be rolled into the new basic rate for business customers. The Commission finds this proposal reasonable.

We also find ORA's recommendation that the lost ARC revenue of $19,341 be rolled into business rates reasonable. Kerman provides no justification why the EAS and ARC charges should be treated differently. Therefore, a total revenue adjustment of $78,653 should be rolled into Kerman's new business service rate of $36.30.

10.3. Universal Service Fund and Intrastate Access Revenues

ORA states that it confirmed Kerman's representations regarding mandatory Universal Service Fund (USF) charges compared to those in the 2015 NECA calculation. ORA notes that while Interstate USF revenue fluctuated between 2010 and 2014, it averaged $1.95 million per year. Kerman projects an increase in 2015 to $2 million, which is forecasted to continue in 2016. ORA accepts Kerman's estimate.

ORA also accepts Kerman's projections for Intrastate Access revenues, which Kerman derived by applying growth rates to an estimated 2014 annual

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104 *Id.*

total. Kerman used a 2012-2013 growth rate for the special access volume charges, but used judgment-based growth rates for switching, originating and terminating volume changes.[105]

We find Kerman's projections and ORA acceptance of USF and Intrastate Access revenues reasonable.

11. Discretionary Revenue

Kerman offers certain telecommunications services which are not part of basic telephone service, including inside wire maintenance service, caller ID service, call waiting and rental telephone equipment. ORA describes these services as discretionary because customers do not necessarily need them and Kerman is not required to provide them. Kerman disagrees with ORA's characterization, and argues that because they are included in Kerman's tariffs, Kerman is required to provide them.[106]

Kerman's revenue projection for local network services for test year 2016 is $1,759,865.[107] ORA estimates that Kerman should earn $2,118,030 in revenues from local services priced more reasonably. ORA also adjusts the methodology for estimating growth rates. The difference between Kerman's estimate and ORA's is $358,165.[108]

Kerman argues that the filed rate doctrine forbids a regulated entity to charge rates for its services different from those filed with the appropriate

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105 Exhibit ORA-1 at 22.

106 Kerman Reply Brief at 56.

107 Exhibit ORA-1 at 7. Increased to $1,850,745 in Kerman's April 16, 2015 rebuttal testimony.

108 This difference includes the adjustment of $78,653 attributable to business basic rate differences as discussed in Section 12.

authority. Kerman's argument that it "must" provide customers with optional services is false. The difference is that Kerman may choose to discontinue offering optional services such as inside wire maintenance service, but Kerman may not choose to discontinue offering basic telephone service because it is the carrier of last resort.

ORA's primary assertion is that Kerman is offering certain services at rates that are far below the rates charged for similar services by other carriers. ORA argues that undercharging for similar services results in other customers subsidizing the provision of these optional services through the CHCF-A. ORA notes that Pub. Util. Code § 275.6(c)(3) requires the Commission to find that rates charged are "reasonably comparable" to rates charged to customers of urban telephone corporations.

Kerman's response to ORA's proposal to increase rates for optional services is that the increases could place these services out of reach for many of Kerman's customer's. Kerman also states that many of its senior citizens use these services. Kerman is essentially arguing that it must charge well below market rates for all of its services. Kerman does not rebut the argument that its rates are not reasonably comparable.

11.1. Tariff A-22 Employee Discounts

Kerman offers its employees a 50% discount for phone service. ORA recommends that Kerman eliminate the employee discount because Kerman's basic service residential rates are already heavily discounted due to the CHCF-A subsidy and only six of Kerman's employees work full time for Kerman.

Kerman argues that its employee discount is an important benefit that helps Kerman attract high–quality employees. Kerman further argues that the fact that Kerman utilizes these employees across different business platforms does not diminish the reasonableness of offering a discount.[109]

Given that Kerman's basic service rate is heavily subsidized by Kerman customers and telecommunications ratepayers in general through the CHCF-A, and only six of Kerman's 69 employees work full-time for Kerman, although all 69 are gainfully employed by Kerman and one or another affiliate of Kerman, the Commission finds an employee discount of 50% unreasonable.

We do not dispute the quality of Kerman's employees or whether they deserve a discount. The question here is whether the discounts should be underwritten by the CHCF-A. Our decision does not preclude Kerman shareholders from providing discounts to its employees.

The Commission's disallowance of a 50% employee discount for telephone service results in an additional $5,172 in local network revenues.

11.2. Tariff A-28 Custom Calling Features

Kerman's Tariff A-28 describes the rates for custom calling features, which are not included in Kerman's basic service. The custom calling features include caller ID, call waiting, call forwarding, three-way calling, and anonymous call rejection. For each of these services, ORA suggests that Kerman is undercharging for its services relative to other carriers, contrary to Public Utilities Code Section 275.6(c)(3). ORA's comparison of some of Kerman's and AT&T's custom calling rates, and ORA's proposed custom calling rates is shown in Table 7.

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[109] Exhibit KTC-12 at 4.

Table 7

	Kerman's Rates	AT&T's Rates	ORA's Proposal for Res. & Bus.
Caller ID	$6.17	$9.99	$9.99
Call Waiting	$3.23	$9.00	$8.50
Call Forwarding	$3.23	$7.50	$6.50
3-Way Calling	$3.23 Res. $5.00 Bus.	$7.50	$7.00
Anonymous Call Rejection	$3.00 Res. $5.00 Bus.	$7.50	$6.50

Pursuant to Section 275.5(c)(3), the rates for Kerman's custom calling features must be "reasonably comparable" to the rates that urban customers pay. ORA's recommended rates for the Tariff A-28 services are reasonable. Therefore the Commission adopts ORA's recommended rates for Tariff A-28 which increases Kerman's local network revenue projections by $101,761.[110]

11.3. Tariff A-32 Inside Wire Maintenance

Kerman's Tariff A-32 covers inside wire maintenance service. Kerman's inside wire maintenance service includes installation of the service and the monthly maintenance charges and Kerman charges $1.10 per month for the service.

Again, ORA points out that pursuant to Section 275.5(c)(3), Kerman's rates, including those for discretionary services, must be "reasonably comparable" to the rates that urban customers pay. ORA points out that as of 2013, AT&T and

[110] Exhibit ORA-1 at 14.

Verizon charge $8.00 and $7.99 respectively. ORA recommends that Kerman increase the charge for inside wire maintenance to $7.50 per month for residential customers and $8.00 for business customers. According to ORA, raising these rates would generate an additional $151,073 in 2016 revenues.[111]

Kerman contends that the value of inside wire maintenance service would be diminished if ORA's proposed rate changes were adopted. Kerman states that this service acts as an insurance policy for customers against potential inside wire repair services that may be required.

Kerman states that it has 1,143 Lifeline customers who subscribe to the inside wire service for $1.10 per month (61.8% of inside wire subscribers). Although it has not done any elasticity studies to identify the effect of ORA's proposal,[112] Kerman states that it expects a minimum reduction of 50% in the customer counts for this service if ORA's recommendation is adopted.[113] Kerman then assumes that 90% of current inside wire customers would decline future inside wire service, and argues that based on this customer loss, the revenues should be estimated at only 10% of the proposed revenue, or $17, 765.[114]

Kerman also argues that because Kerman serves a low-income area, many of its customers would discontinue this service if ORA's proposed rate was adopted.[115] Kerman also argues that adopting ORA's proposal would cause the company to experience "a significant reduction in both customers and revenues."

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111 Exhibit ORA-1 at 14.

112 Exhibit KTC-12 at 13.

113 *Id.* at 15.

114 *Id.* at 16.

115 *Id.* at 14.

Kerman recommends the Commission create a memorandum account to allow a "one-time and recurring adjustment to the CHCF-A draw" so that Kerman can adjust for the actual "demand loss" from this proposal.[116]

ORA states that Kerman's position is essentially that it may lose customer lines as a result of the inability to undercharge for inside wire maintenance service. Kerman is not arguing that the actual cost of providing inside wire maintenance service is in the neighborhood of its $1.10 per month charge or indeed any particular amount. Instead, Kerman argues that its customers are low income and therefore to keep its customers, it should be permitted to continue to offer inside wire maintenance service at a substantial discount compared to AT&T and Verizon.

The Commission finds that Kerman's rates for inside wire maintenance are not "reasonable comparable" to the rates that urban customers pay, as required by Pub. Util. Code § 275.6(c)(3), and are, therefore, not reasonable. A review of Commission documents from Communications Division—which the Commission takes official notice of pursuant to Rule 13.9 of the Commission's Rules of Practice and Procedure--reveals that omparable small local exchange carriers rates for inside wire maintenance range from $1.75 (last updated in 1997) to $5.00 (last updated in 2009). These rates are between 7 and 19 years old. Additionally, we acknowledge the possibility of demand reduction due to rate increases of discretionary services and find it reasonable to apply a 25% attrition rate to residential business subscriber numbers. Therefore, the Commission finds that increasing rates for inside wire maintenance to $5.00 per month for

[116] *Id.* at 16.

residential and business customers is reasonable. Increasing these rates will generate an additional $61,841.

11.4. Growth Rates

ORA asserts that in addition to the revenue differences created by Kerman's underpriced discretionary services, revenue projections are also affected by the difference in growth rate projections. Kerman forecasted its growth rate using the years 2012-2013, resulting in an 87% growth rate, meaning a forecasted decline of 13% of customers who subscribe to the custom calling features. ORA argues that usage rates for this service have remained fairly steady over time. ORA compares a three-year average growth rate in 2012-2014 of 97%, and a five-year average of 2010-2014 of 100% to Kerman's one-year growth rate of 87%. ORA projections result in revenue of $100,674, an increase in revenue of $17,766 above Kerman's revenue projections for custom calling features such as residential caller ID and call waiting.

In rebuttal, Kerman explains that it "modified growth rates in certain instances where prior periods seemed to indicate higher numbers for some reason, "[117] but that it can support ORA's adjustment on this point. This adjustment would add $17,766 to Kerman's proposed revenue calculation.

The Commission adopts the parties' projected growth rates as reasonable. The adjusted growth rates result in increased revenue of $17,766 for custom calling features such as caller ID and call waiting.

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[117] Exhibit KTC-12 at 18.

11.5. Call Waiting Caller ID

ORA states that Kerman does not assess a separate charge for residential or business call waiting caller ID and recommends an $8 per month charge for these services that results in an additional revenues of $7,296.

Kerman admits that its tariff does not assess a separate charge for residential or business call waiting ID services. Kerman explains that there is no separate charge for call waiting ID services since customers who purchase both call waiting and caller ID, have call waiting ID included in their services.

The Commission finds Kerman's explanation of how these services are provided and represented in its tariff reasonable. Therefore we do not increase the revenue for call waiting caller ID.

11.6. Directory Assistance Revenue

Kerman agrees with ORA's recommendation that 2016 projected revenues should include $2,200 in directory revenue.[118]

The Commission finds the parties' recommendation regarding $2,200 in directory assistance revenue reasonable. Adopting the recommendation results in an additional $2,200 in Kerman's projected revenue for 2016.

11.7. Late Fees

Kerman agrees with ORA's recommendation that 2016 projected revenues should include $6,306 for anticipated late fees, stating that it inadvertently failed to charge late fees for certain customers.

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118 *Id.* at 3.

The Commission finds the parties' recommendation regarding $6,306 in late fee revenue reasonable. Adopting the recommendation results in an additional $6,306 in Kerman's projected revenue for 2016.

11.8. Customer Premises Equipment (CPE)

ORA recommends that revenue generated from CPE be added to Kerman's revenue for ratemaking purposes. CPE is the telephone equipment that Kerman rents to its customers. Kerman reported no revenue for CPE maintaining that it is outside the Commission's jurisdiction to count CPE revenue as part of Kerman's ratemaking calculations.[119]

ORA likens CPE to a company truck, or other company equipment. The sale and manufacture of these items is not regulated by the Commission, but the Commission must determine the reasonable level of associated costs to include in rates.[120] ORA cites D.13-09-038 that holds, "states have no role whatsoever in overseeing CPE manufacture or distribution" but asserts the decision does not address the costs or revenues associated with CPE. ORA recommends that Kerman's revenue be increased by $6,288 to account for the 71 customers who are charged $2 per month for CPE and thereby reduce the CHCF-A subsidy by an equal amount.

Kerman states that unlike a company truck, it does not own the CPE and the CPE is not used by the company in serving customers. Kerman states its affiliate owns the CPE. Kerman also asserts that expenses associated with CPE

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[119] Exhibit KTC-12 at 19.

are not generated by the company and therefore the CPE revenue should not be included in revenue.

The Commission does not adopt ORA's recommendation to include revenue generated from CPE in Kerman's revenue for ratemaking purposes. The CPE is not owned by Kerman, but an affiliate. The costs associated with CPE are not generated by Kerman and therefore, including $6,288 of CPE revenue in Kerman's revenue is unreasonable.

12. Plant, Depreciation and Rate Base Adjustments

12.1. Plant in Service

ORA approves of Kerman's "Five Year Plan" for additions to plant with one minor adjustment for depreciation of copper assets. Kerman's five-year plan includes projects for the development of Fiber to the Home (FTTH) infrastructure throughout downtown Kerman and eventually to customers outside of the downtown area. Kerman's estimated total for all the projects over the three years considered in this rate case is $7,811,197, which would be added to Kerman's rate base.

The FCC found that 53% of individuals who live in rural areas lack access to minimum broadband benchmark speeds of 25 Mbps download/3Mbps upload, compared to 8% of urban areas. Kerman states that a fiber network based on the FTTH technology is necessary to provide high speed service to its unserved or underserved customers.[121] By completing the proposed projects, Audeamus, Kerman's affiliate would be able to deliver broadband speeds to the Kerman service area that match the speeds of urban systems.

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[121] Exhibit KTC-4 at 7.

ORA believes there are safety benefits to the FTTH projects. For example, during emergency situations fiber systems allow for rapid communication between emergency service providers. However, ORA points out two safety concerns identified by the Commission; lack of requirements governing back-up power and consumer notification and education about the impact of the transition.[122]

ORA states that in the event of a power outage, copper based telephone systems are able to maintain service. Copper wires maintain an electric current provided by a central office and do not require any outside power. These central offices maintain multiple forms of backup power generation, from battery storage systems to diesel generators, allowing all phones in an area that are directly connect to the line (excluding cordless/wireless phone systems) to remain viable methods of communication.[123] The life of most back-up power sources is only 4 – 8 hours and the use of back-up power changes customer expectations of how telephone service is provided. In this case, who is responsible for maintenance of back-up power? ORA recommends that Kerman be required to submit a Tier -3 Advice Letter six months after a final decision in this proceeding proposing a plan to mitigate potential safety concerns and to educate customers about new responsibilities they must undertake.

Kerman states that it currently monitors the battery life for all of its fiber-to-the-home customers, has an alarm system that provides notice that

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122 Comments of the California Public Utilities Commission, In the Matter of Ensuring Customer Premises Equipment Backup Power for Continuity of Communications, PS Docket No. 14-174, Feb.26, 2015, at 3-7.

123 Exhibit ORA-1 at 56.

battery issues exist, and Kerman has assumed responsibility for replacing these batteries. Kerman also provides a notice to every customer that is put on fiber-to-the-home facilities, both at the time service using fiber facilities is initiated and every year thereafter in an annual notice. This notice identifies the issues related to power outages, phone limitations with corded and cordless phones, and battery life issues. It also indicates the length of time the battery may last and that customers can obtain additional batteries and keep them on hand if they choose.[124]

The Commission finds Kerman's plans regarding back-up power and information for customers adequate and therefore reasonable. No additional reporting is required.

12.2. Accelerated Copper Depreciation

Kerman proposes to replace its current copper based services with FTTH technology at a cost of $7,811,197 added to rate base. Kerman is requesting accelerated depreciation of its Buried Metallic Cable and Wire Facilities[125] which are associated accounts of the copper wire infrastructure. Kerman states that copper depreciation is necessary because metallic cable facilities are not capable of providing the services customers will need and therefore these facilities will likely need to be replaced long before they become fully depreciated.[126]

ORA states that Kerman's current copper plant is still useful and in good repair and has the capacity to exceed current CPUC and FCC minimum standards for

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124 Exhibit KTC-5 at 3.

125 Exhibit KTC-4 at 10-11.

126 *Id.* at 11.

broadband services in rural areas.[127] ORA asserts that Comcast already serves over 70% of the Kerman area and that Kerman is asking to remove useful copper and depreciate it at an accelerated rate so that it can advance its five year plan. ORA asks the Commission to require Kerman's shareholders to absorb the accelerated depreciation ($350,031) while still receiving the full $7.8 million cost of the FTTH project.[128] ORA states that this is a more equitable distribution of the costs of building the fiber networks immediately.

Although Kerman states that copper depreciation is necessary because the facilities will likely need to be replaced long before they become fully depreciated, we agree with ORA that the facilities are still used and useful. Therefore, we find that amortizing the remaining $350,031 depreciation of the existing copper wire over the 5-year period of the FTTH project is reasonable.

12.3. Other Work Equipment (OWE)

Kerman's proposal for Plant in Service for test year 2016 includes an account for OWE. According to Kerman, this account includes construction equipment such as cable plows, boring rigs, cable testing equipment, work equipment trailers, splicing equipment, and concrete saws.[129]

For test year 2016, Kerman projects the OWE account to have an average balance of $1,249,638, with related accumulated depreciation of $566,870. A net total of $682,768 associated with OWE is included in rate base.[130]

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[127] WC Docket No.10-90, FCC 14-90, Dec.18, 2014 at 6 and CPUC D.12-02-015, Feb. 1, 2012, at 17.

[128] Exhibit ORA-1 at 59.

[129] Exhibit KTC-4 at 9.

[130] Exhibit KTC-12 at DC-3.

ORA maintains that Kerman's rate base should exclude the entire plant balance recorded in the OWE and any related accumulated depreciation for this account on the basis that Kerman does not use the equipment to provide service to customers. ORA asserts that instead, Kerman rents or leases the equipment to its unregulated construction affiliate, Kertel Communications.[131]

ORA recommends that Kerman's 2016 Plant in Service be adjusted to remove this account and its associated effects on rate base and depreciation expense, while removing the credit to the related expense account for the $17,154 in rental fees that Kertel paid to Kerman in 2014. The net adjustment would result in a decrease to Kerman's revenue requirement in the amount of $138,852.

As support for its position, ORA cites a telephone conversation with Mr. Clark and Carolyn Dukes on March 11, 2015. ORA also cites a Data Response provided by Kerman in which Kerman states that "2116.10 Other Work Equipment" is provided on a time leased basis to the affiliate and is also reflected as an offset to the Other Work Equipment expense accounts (611410 and 61120).[132]

Kerman further states that "[w]ith the Other Work Equipment ('OWE") account, Kerman develops an hourly lease rate using the GE-100 model that was developed by the Commission for determining such items as lease rates."[133]

In addition, ORA argues that the hourly lease rates that Kerman charges its unregulated affiliate Kertel are problematic because they are extremely outdated.[134]

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131 Exhibit ORA-1 at 60-61.

132 Exhibit ORA-1 at Attachment 3-8 (page 4 of 5).

133 *Id*.

On rebuttal, Kerman's witness Kehler states that there are two different types of equipment in the OWE category. The first type includes $416,050 of "test equipment, tools, generators, and other equipment that are used on a fairly regular basis or as needed and used on site in emergency situations."[135] According to Kehler, the second type of equipment are "larger construction equipment such as backhoes, trenchers, horizontal directional drill rig, cable dollies, and associated trailers." According to Kehler, "this equipment constitutes $805,677 of the OWE and is the issue in ORA's testimony."[136]

Kehler states that "the company" uses the OWE equipment it has to deal with these issues. Kehler asserts it is more cost effective than having the construction company bring its equipment to Kerman to address limited issues.

Kerman's witness subsequently testified that Kerman does in fact use the OWE itself for installation and repair. The witness did not explain why his testimony contradicted the previously provided information that OWE is leased to the affiliate. This information was provided to ORA in response to a data request. ORA posits that this makes the testimony less reliable. ORA states that, it is worth noting that among the services provided by "Audeamus to telco" as identified in Attachment 2-24, of Exhibit ORA-1, is the service "regulated installation and repair services."

ORA states that it researched lease rates for similar equipment and provided a comparison of rates as shown in Table 8.[137]

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[134] Exhibit ORA-1 at 61.

[135] Exhibit KTC-5 at 4.

[136] *Id*.

[137] Exhibit ORA-1 at Attachment 3-9 through 3-14.

Table 8

Kerman Rates		**Competitive Rates**	
Equipment	**Daily Rate**	**Equipment**	**Daily Rate**
Generator 7200 Watt	$3.23	Generator 7500 Watt	$66.00
Backhoe Deere 3000	$36.00	4 WD Std. Backhoe	$275.00
Forklift 10,000 lb.	$36.95	Forklift 10,000 lb.	$379.00
Ditch Witch 6510	$56.71	Ditch Witch 4500	$414.00
Air Compressor Leroi	$24.51	Air Compressor 375 CFM	$225.00

Based on the current market rental information presented by ORA for similar equipment in the Kerman area, it is clear that the lease rates paid by the affiliate to Kerman for use of the OWE are far too low. Kerman's reliance on outdated lease rates is unreasonable. As with all other expenses, Kerman bears the burden of proving that its plant is used for utility purposes and that the lease rates used are reasonable. Kerman has not provided sufficient information to support its proposed lease rates.

We agree with ORA that the use of extremely outdated GE-100 lease rates is unreasonable. The fact that Kerman believes it is appropriate to charge its affiliate such outdated rates increases our concerns regarding Kerman's affiliate transactions. The Commission is under no obligation to periodically provide the small LECs with updated lease rates. Instead, it is the small LECs responsibility to demonstrate that its costs are just and reasonable. Furthermore, the affiliate rules are clear that the affiliate must pay the market rates for goods and services provided by the utility. In this case, it is clear that the affiliate is not paying the market rate.

We are also concerned that Kerman's witnesses contradict the information previously provided to ORA in response to a data request. It raises a credibility issue with the subsequent testimony.

Nonetheless, because we believe the OWE is used by Kerman to provide service to its customers and therefore used and useful, and the larger equipment is available in case of emergencies, we will include the $1,249,638 plant balance, minus accumulated depreciation of $566,870, for a net plant value of $682,768, in rate base. However, in the future Kerman must use market rates from equipment rental companies in the Fresno area when renting equipment to Kertel or any other affiliate or non-affiliated entity. A rental agreement/ticket must be created for every instance of Kerman renting OWE to another entity. This includes all OWE equipment listed in the Rebuttal Testimony of Eric Kehler, dated April 16, 2015, Attachment EK-3. Each ticket must show what piece of equipment was rented, when and for how long and by which entity. The total could then be calculated and charged by Kerman. This process must be more than an accounting entry. The documentation must be available to Commission staff to review at any time and retained until after the next general rate case.

13. Chamber of Commerce Use of Kerman's Central Office Building

During the evidentiary hearing on April 29, 2015, Kerman Witness David Clark confirmed that Kerman's Chamber of Commerce occupies the old central office building, which is one block from Kerman's current central office building.

When the witness was asked if the Chamber of Commerce pays rent, the witness was unsure.[138] Since this property is owned by Kerman, and is being occupied by the Chamber of Commerce, Kerman should be collecting market rate rent and reporting it as revenue. Kerman's failure to do so is unreasonable.

In order to impute rental income for the space, the Commission's Communications Division did an Internet search of available rental properties in Fresno, CA[139] and found six office spaces for rent. The rents ranged from $12 to $22 per square foot per year with the average being $16.90 per square foot. If we assume the Chamber of Commerce occupies 2,000 square feet of office space, the monthly rent is $2,817 and the annual rent is $33,800, at the average cost per square foot of $16.90. The Commission takes Official Notice of these rental figures pursuant to Rule 13.9 of the Commission's Rules of Practice and Procedure.

Because we have found that Kerman not collecting rent from the Chamber of Commerce is unreasonable, the Commission finds imputing rental revenue of $33,800 for the Chamber of Commerce occupancy of Kerman's old central office building is reasonable.

In addition, we will require Kerman to provide our Communication's Division staff with information regarding rental of this office space. No later than 10 days after the effective date of this decision, Kerman shall provide a report to the Commission's Communications Division, and serve the report on the service list of this proceeding, responding to the following questions:

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[138] RT at 295.

[139] http://www.loopnet.com/for-lease/fresno-ca/office/?e=u

- Does the Kerman Chamber of Commerce rent the Old Central Office Building?
- How much rent does the Chamber of Commerce pay?
- How many square feet is the building and how many square feet does the Chamber of Commerce occupy?
- Are any other tenants of the Old Central Office Building?
- Are there executed leases for occupants of the old Central Office Building? If so, provide copies of the leases.
- If there are no executed leases for tenants of the Old Central Office Building, explain why.
- What is comparable office space leasing for per square foot in Kerman? Provide three examples of office space lease rates in the area.

14. Affiliate Transaction Issues

The second amended scoping memo and ruling states that the "[i]dentification of all Kerman affiliates and the affiliate revenues, consistent with section 275.6" as being within the scope of the proceeding.[140] In ORA's Corrected Report and Recommendations, it asserts that Kerman, along with its affiliates, does business under the name Sebastian, and that in "addition to creating a tangle of business records that are difficult to segregate, the business name and organizational structure of Kerman" allows unregulated affiliates to reap the benefits and rewards.[141] In its Opening Brief, ORA alleges that Kerman failed to demonstrate that its transactions with its affiliates were conducted on an arms-length basis to protect ratepayers and avoid excessive costs and that as a result, the CHCF-A is subsidizing the expenses and operations of unregulated

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[140] Second Amended Scoping Memo and Ruling at 8.

[141] Exhibit ORA-1(a) at 3.

non-telephone companies.[142] Although not set forth in its Corrected Report and Recommendations, ORA's Opening Brief makes nine recommendations to separate Kerman's operations from its parent company and its affiliates by requiring Kerman and its affiliates to do the following:

- Be held in separate legal entities.
- Maintain separate books for all transactions.
- Maintain separate bank accounts for all transactions.
- Have no joint advertising or marketing.
- Have no overlapping of employees or responsibilities.
- Have no joint events, sponsorships, fundraisers, or charitable donations.
- Not transfer any physical assets without first obtaining the necessary approvals from the Commission.
- Conduct financial transactions with each other at "arms-length."
- Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to Kerman from unaffiliated third parties for similar transactions.[143]

Kerman challenges ORA's affiliate interaction and structure proposals on a variety of grounds. Kerman argues that the Commission cannot and should not consider the proposals because they are outside the scope of the proceeding, were never examined during the evidentiary hearings (thus denying Kerman of the opportunity to examine ORA's witnesses about the basis for the proposals),

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142 ORA's Opening Brief at 5. In support, ORA refers to the discussion of Other Work Equipment and Kertel's maintenance and construction for KTC, which are discussed in Exhibit ORA-1(a) at 3, 46, and 60.

143 *Id.* at 5-6.

and are inconsistent with prior Commission precedent and federal law.[144] Kerman further asserts that if the Commission were to consider and adopt ORA's proposals, the Commission would not be acting as required by law since the decision would be resolving an issue that is not identified in the Scoping Memo.[145] But it is also true that Kerman did submit rebuttal testimony from William Barcus on ORA's charge in its report and recommendations that Kerman has a "tangle of business records that are difficult to segregate."[146]

Given the state of the record and the challenges that Kerman has made, it is necessary for the Commission to discuss its authority to address affiliate- transaction issues in general, ORA's recommendations in particular, and the level of notice that must be provided to an applicant that the Commission may address affiliate transactions in its decision.

14.1. Commission Authority and Standards for Addressing the Legality and Structure of Affiliate Relationships and Transactions

In D.81896, wherein Continental Telephone Company of California sought permission to increase the rates charged for classified directory advertising, the Commission stated it "has often expressed its concern with affiliated interests and their impact on the cost of service furnished to the public." D.81896 cautioned that when a utility purchases services, commodities, capital equipment, the construction of new properties, and the use of funds from its parent or an affiliate:

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[144] Kerman's Reply Brief at 66-67.

[145] *Id.*

[146] Exhibit KTC-2 at 4:7-16.

> There is an absence of arm's length bargaining with the loss of all of the protection which independent bargaining affords both the investors and the consumers. The unregulated development of affiliated relationships with utilities subject to our jurisdiction forces us to scrutinize affiliated intercompany transactions when a rate case is being considered to safeguard the interests of consumers and investors.

The Commission echoed its policy to protect the ratepayer from utility burdens years later in *Re Pacific Bell*,[147] in which Pacific Bell had filed an application requesting authority to increase intrastate rates. The Commission set forth its duty to analyze affiliate relationships in order to protect ratepayers from having to pay higher service rates to subsidize excessive payments to unregulated affiliates:

> The Commission has historically scrutinized transactions between regulated utilities and affiliated corporations, and has in several cases imposed disallowances to account for excessive payments to unregulated affiliates. These actions have been premised on the need to carefully scrutinize affiliated transactions given the inherent lack of arms-length bargaining.[148]

D.81896 and *Re Pacific Bell* provide clear direction that in proceedings seeking rate increases, this Commission must ensure that the prices that a regulated company charges its affiliates for its goods and services should be the same as those they would charge other competitors in arms-length transactions (*i.e.,* transaction in which the parties involved act independently of each other, and without some special relationship.)[149] Ideally, affiliates should purchase

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[147] D.87-12-067, 27 CPUC 2d 1.

[148] 27 CPUC 2d at 96.

[149] *See Allegheny Ludlum Corp v. U.S.* (Fed. Cir. 2004) 367 F.3d 1339, 1348 ("An authoritative legal dictionary defines 'arm's-length' as 'of or relating to dealings between two parties who

Footnote continued on next page

services from the telephone company under tariffs equally available to all. Similarly, prices for goods and services that the carrier pays its affiliates should be the lower of cost or market value. To ensure these protections, the Commission has exercised its authority to open rulemakings in order to adopt and revise its regulations for utilities and their affiliate transactions.[150]

This Commission went further in *Re Pacific Bell* and explained that its power to investigate and disallow unreasonable affiliate expenses is grounded in authority recognized by the California Supreme Court:

> The California Supreme Court has held that for ratemaking purposes, the Commission may disallow excessive and unreasonable payments between affiliated corporations (*Pacific Telephone and Telegraph Company v. Public Utilities Commission* (1965) 62 Cal. 2d 634 at 659.) In addition, the Commission may disregard the separate corporate entities established around the regulated enterprise and may regard the operations of the separate entities and the operations of the corporate enterprise as a whole (*General Telephone of California v. Public Utilities Commission* (1983) 34 Cal. 3d 817; *City of Los Angeles v. Public Utilities Commission* (1972) 7 Cal. 3rd 331 at 344).[151]

As these payments are ultimately borne by ratepayers in the form of higher rates for service, the Commission serves a significant public service by protecting end

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are not related or not on close terms and who are presumed to have roughly equal bargaining power; not involving a confidential transaction,'" quoting *Black's Law Dictionary* 103 (7th ed.1999); and *Santomenno v. Transamerica Life Insurance Company* (2013) U.S. Dist. LEXIS 22354, * 19 ("[A]rm's length negotiations or transactions are characterized as adversarial negotiations between parties that are each pursuing independent interests.")

150 *See, e.g.* D.06-12-029 (*Opinion Adopting Revision to (1) the Affiliate Transaction Rules and (2) General Order 77-L, as Applicable to California's Major Energy Utilities and Their Holding Companies*); and D.93-02-019 (*Order Revising but Denying Rehearing of Rulemaking 92-08-008 with regard to Affiliated Interest Reports Required to be Submitted by Telephone Carriers*).

151 27 CPUC 2d at 96-97.

users from unreasonable service charges. (*See Re Pacific Bell*: "In conclusion, we find that this set of disallowances, additional ratepayer protections, and the exercise of this Commission's authority for ongoing review will appropriately shield ratepayers from any adverse consequences as a result of Pacific Bell's relationships with [its] holding company and affiliates.")[152]

The Commission also stressed in *Re Pacific Bell* that the utility seeking the rate increase plays an active role in assuring the proper separation between it and its affiliates:

> Ultimately, it will be management's decision that determines the future path of diversification and affiliate transactions. A high road result will most probably come from management decision that structurally separate regulated and unregulated operations, protect the regulated company's name, identity, capital, personnel, technology, "know how" and business income and pay a fair price for all interests of value received by the affiliate from the regulated company. The "other road" is full of uncertainties and other dangers caused by confusion of the regulated company's property and interests with the business of the affiliate. We prefer the high road because it is the smooth and sure road into the future.[153]

Yet in saying it is management's decision to determine whether to take the high road, this Commission did not intend to divest itself from its responsibility to scrutinize affiliate relationships and transactions, and to make determinations in order to protect the ratepayer. The California Supreme Court recognized the

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[152] 27 CPUC 2d at 141.

[153] *Id*. at 141.

waning viability of the "invasion of management" rationale in *General Telephone Company v. Public Utilities Commission* (1983) 34 Cal. 3d 817, 824.[154]

Furthermore, while in *General Telephone*, the California Supreme Court was faced with the issue of whether to affirm the Commission's order that General Telephone implement a competitive bidding procedure, it relied on statutes conferring broad authority on the Commission, statutes that we find are also applicable to the Commission's ability to adopt rules regarding affiliate transactions: Pub. Util. Code §§ 728,[155] 761,[156] and 701.[157] In construing these

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[154] "Later cases, however, have cast serious doubt on the continuing vitality of much of the reasoning in *Pac. Tel*. The *Pac. Tel.* court's primary justification for refusing to imply the commission's power to regulate the arrangement between Pacific and American was the 'invasion of management' rationale. [Citation omitted.] Nevertheless, only a few years later, we severely limited the 'invasion of management' argument in *Southern Pac. Co. v. Public Utilities Com.* (1953) 41 Cal.2d 354 [260 P.2d 701]." And as the "invasion of management" rationale has waned, the California Supreme Court said "we have been more willing to permit regulatory bodies to exercise powers not expressly stated in their mandate[,]" citing to *Ralphs Grocery Co. Reimel* (1968) 69 Cal.2d 172, 176 ("In determining whether a specific administrative rule falls within the coverage of the delegated power, the sole function of this court is to decide whether the department reasonably interpreted the legislative mandate.) and *Ford Dealers Association v. Department of Motor Vehicles* (1982) 32 Cal. 3d 347, 362 ("[The] absence of any specific [statutory] provisions regarding the regulation of [an issue] does not mean such a regulation exceeds statutory authority…").

[155] "Whenever the commission, after a hearing, finds that the rates or classifications, demanded, observed, charged, or collected by any public utility for or in connection with any service, product, or commodity, or the rules, practices, or contracts affecting such rates or classifications are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the commission shall determine and fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force."

[156] "Whenever the commission, after a hearing, finds that the rules, practices, equipment, appliances, facilities, or service of any public utility, or the methods of manufacture, distribution, transmission, storage, or supply employed by it, are unjust, unreasonable, unsafe, improper, inadequate, or insufficient, the commission shall determine and, by order or rule, fix the rules, practices, equipment, appliances, facilities, service, or methods to be observed, furnished, constructed, enforced, or employed. The commission shall prescribe rules for the performance of any service or the furnishing of any commodity of the character furnished or

Footnote continued on next page

provisions against the challenge to the Commission's regulatory authority, the California Supreme Court found that:

> ... since the major purpose of the order concerning competitive bidding for COSE was better service for the consumer, rather than an officious desire to run General's business, *Pac. Tel*. is not applicable. With that legal roadblock out of the way, the basic powers of the commission, contained, *inter alia*, in sections 701, 728 and 761 are ample to sustain the challenged order.[158]

Thus, in any rate increase request such as the one filed by Kerman, as well as the one resolved in *Re Pacific Bell*, both affiliate scrutiny and the responsibility to take prophylactic measures action are imbedded in the proceeding by virtue of settled statutory and judicial law vesting the Commission with such authority.

14.2. Kerman's Burden of Proof

We must also articulate and affix the appropriate burden of proof. While Kerman claims that timing of ORA's affiliate-transaction proposals affected its ability to confront ORA's witnesses, it is important to remember that Kerman, as the applicant, bears the burden of proving that its affiliate transactions are reasonable and need not be revised. In D.81896, the Commission stated:

> A special burden must be borne by the applicant in a rate case to demonstrate conclusively not only that affiliated intercompany transactions are reasonable in that they do not create a burden on the consumer, but that the affiliated relations afford the maximum

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supplied by any public utility, and, on proper demand and tender of rates, such public utility shall furnish such commodity or render such service within the time and upon the conditions provided in such rules."

157 "The commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."

158 34 Cal. 3d at 827.

> gains in efficiency or productivity and the greatest savings in costs to the consumer.

In other words, Kerman bears the burden of proving that its affiliate relations are of such a reasonable nature where the ratepayer is concerned that the Commission would not need to consider any additional affiliate-transaction proposals.

14.3. Kerman Has Not Met its Burden of Proving That its Affiliate Transactions Did Not Create a Burden on California Consumers

14.3.1. Connections Between Kerman and Its Affiliates

From the Evidentiary Hearing, we can discern multiple examples that demonstrate a lack of separation between Kerman and its affiliates:

Corporate structure: Kerman is wholly owned by Sebastian Enterprises, Inc. (SEI) and operates under the fictitious business name Sebastian. (KTC-01 at 1:20-22.) SEI is the parent company of four affiliates: Kerman, Foresthill, Audeamus, and Kertel. (*Id.* at 2:23-24.) The testimony of David Clark expands on this corporate structure and states: "Kerman's affiliates are as follows: Sebastian Enterprises, Inc. (SEI)—parent company, Foresthill Telephone Co., Kertel Communications, Inc., Audeamus, CVIN, LLC, S&K Moran Limited Partnership, and Barcus Family Limited Partnership." (KTC-07(a) at 25:23-25.)

Corporate operations: Kerman and Foresthill are rural incumbent local exchange telephone companies that provide regulated local exchange telephone service and related services. (KTC-01 at 2:24-26.) Audeamus provides toll service and a range of what it terms non-regulated services such as video, Digital Subscriber Line, and alarm system services. (*Id.* at 3:1-2.) Kertel is a construction company that provides electrical and low voltage construction and non-telecom-related services. (*Id.* at 3:2-4.)

Corporate designation: Kerman and the other subsidiaries do business as Sebastian. (RT 4/28/2015, 55:19-24; KTC-01 at 3:4.)

SEI is a holding company for Kerman Telephone Company and Foresthill Telephone Company. (RT 4/28/2015, 49:24-50:3.)

Location: Kerman, Sebastian and Audeamus are located at 811 South Madera, Kerman, California according to records reviewed from the California Secretary of State.

Rental agreements: Kerman rents the entire Central Office Building. But there are employees there from the internet affiliate that serves Kerman customers.

Service: Kerman, Kertel, Foresthill, and Audeamus use trucks marked Sebastian. (RT 4/28/2015, 56:4-6; 28-57:3-13.)

Sponsorships: Certain event sponsorships are done under the name Sebastian. (RT 4/28/2015, 59:24-60:5.)

Finances: by Kerman's own testimony, its finances have a "complexity" to them that is a "natural consequence of compliance" with "FCC accounting a separation rules." (KTC-2 at 4:11-12.) It is not certain, standing alone, what FCC accounting and separation rules this testimony is referencing. Though with some cross referencing, we see that another of Kerman's witnesses -- under the heading SEPARATIONS -- refers to the FCC and the Code of Federal Regulations, Title 47, Part 36 regarding rules "governing allocation of the total costs to the interstate jurisdiction for telecommunications companies" (KTC-07(a) at 15:1-2.) yet these separation rules do not appear to address separation of finances between a parent and its affiliate.

14.3.2. Connections Between Kerman and Its Affiliates Create a Burden on California Consumers

The question that must be addressed is whether this connectedness is creating a burden on the consumer that would warrant the adoption of ORA's proposals. In its testimony, ORA claims that this organizational structure facilitates the loading of costs that benefit its unregulated affiliates at ratepayer expense.[159] As examples, ORA cites to (1) the "Other Work Equipment," which includes costs of construction equipment that is not primarily used by the regulated entity but is included in the regulated rate base; (2) Kertel's maintenance and construction for Kerman; (3) IT services that are provided without a contract; and (4) image marketing where Kerman pays the majority of the marketing expenses for Sebastian, although the expenses are not related to the services that Kerman provides.[160]Kerman counters that none of the proffered examples defeat the conclusion that Kerman is interacting with its affiliates on an arm's-length basis.[161] But as we discuss further, *infra*, at § 14.4, in our review of the four foregoing examples, we find that there is evidence that California ratepayers have been burdened in the form of unnecessary expenses that should have been born by the affiliates

ORA also argues that Kerman and its three affiliates (FTC, Kertel, Audeamus) do business under the name Sebastian, the Central Office Building is branded Sebastian, bills vehicles, and other items have the name Sebastian, and

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159 ORA Opening Brief at 2 and 5; and ORA-1(a) at 3 (Executive Summary).

160 *Id.*

161 Kerman Reply Brief at 9:27-10:1.

that such a tangle facilitates the loading of costs to the regulated entity while the unregulated affiliates reap the benefits. In response, Kerman argues that not only is there nothing in the record to support ORA's position, but there is also nothing unusual about Kerman's use of a fictitious business name as part of a broader branding strategy.[162] Kerman goes further and claims that it "derives a significant benefit from its association with the Sebastian brand, not the other way around," citing Bus. & Prof. Code § 7532 in support thereof.[163]

Yet Kerman failed to meet its burden of proof. It is up to Kerman to demonstrate that the affiliate transactions do not impose a burden on consumers in the form of higher rates, something that Kerman does not provide evidentiary support for in its post-hearing brief. It is also unclear how Kerman's "significant benefit" results in a benefit for the consumer. Similarly, it is not clear how Bus. & Prof. Code § 7532 protects consumers against burdensome charges that are the result of a corporation's affiliate structure. This provision is located in

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[162] Kerman Reply Brief at 9:4-6.

[163] Bus. & Prof. Code § 7532 states:

> No licensee shall conduct a business under a fictitious or other business name unless and until he or she has obtained the written authorization of the bureau to do so. The bureau shall not authorize the use of a fictitious or other business name which is so similar to that of a public officer or agency or of that used by another licensee that the public may be confused or misled thereby. The authorization shall require, as a condition precedent to the use of any fictitious name, that the licensee comply with Chapter 5 (commencing with Section 17900) of Part 3 of Division 7. A licensee desiring to conduct his or her business under more than one fictitious business name shall obtain the authorization of the bureau in the manner prescribed in this section for the use of each name. The licensee shall pay a fee of twenty-five dollars ($25) for each authorization to use an additional fictitious business name and for each change in the use of a fictitious business name. If the original license is issued in a nonfictitious name and authorization is requested to have the license reissued in a fictitious business name the licensee shall pay a fee of twenty-five dollars ($25) for the authorization.

Chapter 11.3 of the Bus. & Prof. Code and is entitled "Private Investigators." Assuming this reference is not in error, we are at a loss to determine how § 7532 advances Kerman's argument in any manner relevant to this proceeding.

Nor is Kerman's position assisted by the rebuttal testimony of William Barcus. In response to ORA's claim that the Kerman business records are tangled and difficult to segregate, Mr. Barcus refers to the claimed hundreds of hours of time spent with ORA explaining its records, but there is no testimony from Mr. Barcus explaining how the affiliate relations have not placed a burden on the consumer.[164] Mr. Marcus then claims that Kerman's records are consistent with FCC accounting and separations rules, but fails to cite any of those rules or explain how the consumer is protected by the rules.

Given this level of interconnectedness, we believe it is appropriate to consider ORA's proposals to ensure greater separation between Kerman and its affiliates in order to protect ratepayers against unreasonable rate charges.

14.4. The Lack of Arms-Length Transactions Between Kerman and its Affiliates

The four examples cited in § 14.3.2 demonstrate the lack of arms-length transactions between Kerman and its affiliates, the result of which has been the imposition of unnecessary costs onto the ratepayers. We consider each of these examples in order to explain our conclusion.

14.4.1. Other Work Equipment

ORA asserts that Kerman's proposal for Plant In Service during the Test Year 2016 includes an account for "Other Work Equipment," which consists of

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164 KTC-2 at 4:7-10.

construction equipment such as cable plows, boring rigs, cable testing equipment, work equipment trailers, splicing equipment and concrete saws.[165] ORA argues that this category includes the costs of construction equipment that is not primarily used by Kerman to provide customer service. Instead, Kerman leases the equipment in this account to unregulated affiliates that reimburse Kerman at often just 1/10 of the competitive market rate.[166]

In response, Kerman asserts that it is following a longstanding Commission guideline regarding the development of these rates, and cites to Decision (D.) 90-11-029.

But it is unclear how the *Order Approving a Permanent Rate Structure for an Interexchange Telephone Carrier's READYLINE, MEGACOM, and PRO WATS Services* assists Kerman as Kerman has provided no references to the text, findings of fact, conclusions of law, or ordering paragraphs to explain how it is appropriate to charge less than the competitive market rate for a lease.

14.4.2. Kertel's Maintenance and Construction for Kerman

ORA asserts that the majority of Kerman's actual construction (65% in 2014) is procured through Kertel.[167]

In response, Kerman argues that ORA fails to identify anything "problematic about that relationship."[168]

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[165] ORA-1(a) at 60:3-6.

[166] ORA- 1(a) at 3:10-12; and 60:2-61:5.

[167] *Id.* at 3:13-14.

[168] Kerman Reply Brief at 9:20-21.

Yet Kerman fails to demonstrate that Kerman's procurement of construction through its affiliate is not creating a burden for the consumer.

14.4.3. IT Services

ORA asserts that "Kertel provides IT services to Kerman with no contract and basically no documentation."[169] While ORA fails to cite any evidentiary support for this assertion, we have found a reference in the record:

> Now, you mentioned an IT contract. That's with your—with Kerman's affiliate Kertel?
>
> Yes.
>
> Okay. And are you aware that there's no written contract between Kertel and Kerman for the services they provide?
>
> Yes, I am.[170]

In light of this evidence in the record, we reject Kerman's claim that ORA's assertions are "outright fabrications" that are "discussed in further detail herein."[171] In fact, Kerman fails to provide a citation where in its 72-page reply brief this matter is addressed.

14.4.4. Image Marketing

ORA asserts that as of 2014, Kerman indicated that its total actual marketing expenses were $337,069.[172] The regulated entities pay the majority (66.66%) of the marketing expenses with the remaining 33.33% split between the

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[169] ORA Opening Brief at 5.

[170] RT April 28, 2015 at 112:25-113:4.

[171] Kerman Reply Brief at 9:23-24.

[172] ORA-1(a) at 45:19-20.

unregulated affiliates Kertel and Audeamus.[173] Some expenses are not related to customer services and instead go towards hotel stays and restaurant meals.[174] ORA argues that $248,302 should be removed from Kerman's total reported non-corporate expenses for ratemaking purposes.

Kerman counters that the marketing department interacts directly with consumers by coordinating customer education efforts that included battery backup information and the availability of LifeLine services.[175] Kerman argues further that through the marketing department, Kerman develops and provides brochures that describe the services that it offers, information on how to understand a telephone bill, and other public service information that Kerman claims is Commission mandated.[176]

Kerman also argues that the proposed disallowance is flawed as it proposes an allocation to an expense account that has already been allocated between the SEI affiliates.[177] Kerman claims that in fact only 28% of the total marketing expense for all of the SEI affiliates was allocated to Kerman.[178] But what is apparent is that Kerman has not shown that the claimed 28% allocation is not placing a burden on the consumer. For example, Kerman provided the

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173 *Id*. at 46:3-5.

174 ORA-1(a) at 46:6-7.

175 KTC-11 at 37:22-23.

176 *Id*. at 37:22-27.

177 Kerman Opening Brief at 49:1-19, citing to RT May 8, 2015 at 528:7-25; and KTC-11 at 40:13-19.

178 Kerman Opening Brief at 49, citing to KTC-11 at 40:13-19.

rebuttal testimony of Mr. Clark who first explained, generally, the allocation approach:

> Kerman reviews its marketing efforts to determine which companies are involved with specific marketing effort. Kerman then makes an assessment to determine how much each company is affected by the marketing effort. Marketing expenses are apportioned based on this review.[179]

It is unclear how Kerman determined how each company is "affected by the marketing effort" so it cannot be said that the 28% is the appropriate allocation.

We agree with ORA that these expenses do not aid the consumers utilizing Kerman's service.

When we consider the current state of corporate affiliation, along with the examples that SEI has provided, we conclude that Kerman has failed to meet its burden of proving that the current corporate affiliations have not placed a burden on the consumer. We also conclude that ORA's four examples demonstrate that the transactions between Kerman and its affiliates were not conducted at arm's length. As a result, the Commission's concerns can be addressed by the adoption of ORA's proposals to provide greater separation between Kerman and its affiliates.

14.5. Kerman Had Adequate Notice That Changes Might be Proposed to its Affiliate Relations and Transactions Even if the Matter Had Not Been Specifically Identified in the Scoping Memo

Since affiliate transactions are part of rate proceedings, Kerman had adequate notice that changes to its relations with the affiliates might be proposed and considered by the Commission. The question of adequate notice was

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179 KTC-11 at 39:6-9.

addressed in *Pacific Gas and Electric Company v. Public Utilities Commission* (2015) 327 Cal.App.4th 812, Cal.App. LEXIS 512. On August 19, 2013, the Commission issued an order for Pacific Gas and Electric Company (PG&E) to show cause (OSC) why it should not be sanctioned for violating Rule 1.1. But the OSC did not state that the Commission would also consider whether PG&E separately violated Rule 1.1 by failing to disclose the corrected pipeline specification information a month after the first preliminary information was discovered, or that PG&E might face continuing violation sanctions based on any breach of disclosure or filing obligations. (237 Cal.App.4th at 859.) In rejecting the notion that the precise charges must be set forth in the OSC, the Commission stated due process does not require any particular form of notice. The details can be flexible depending on the circumstances, and this is especially true where administrative procedures are concerned. (*Id.* at 860.) All that is required is that the notice be reasonable. In articulating this standard, the Court relied on *Lusardi Construction Co. v. Aubry* (1992) 1 Cal.4th 976, 990; *Drummey v. State Bd. Of Funeral Directors* (1939) 13 Cal.2d 75, 80; *Litchfield v. County of Marin* (1955) 130 Cal.App.2d 806, 813; *Sokol v. Public Utilities Commission* (1966) 65 Cal.2d 247, 254; *Haas v. County of San Bernardino* (2002) 27 Cal.4th 1017, 1037, and *Jonathan Neil & Assoc., Inc. v. Jones* (2004) 33 Cal.4th 917, 936, footnote 7. (*Id.)*

In sum, the Court concluded that a "fair reading of the OSC discloses that the PUC was not merely concerned with how the filing was titled." (237 Cal.App. 4th at 860.)

Applying the above legal standard to the instant proceeding, we conclude that Kerman was given reasonable notice that the Commission might consider proposals—either made by a party in a post hearing brief or on the Commission's own motion—that would impact affiliate relations and transactions. As noted previously, the Kerman scoping memo stated that the "identification of all Kerman affiliates and the affiliate revenues, consistent with section 275.6" was part of the proceeding. The Commission has a duty pursuant to Pub. Util. Code § 275.6 to ensure affordable high-quality communications services in rural areas of the state. Certainly determining if services are affordable will require the Commission to decide if CHCF-A is subsidizing the expenses and operations of unregulated non-telephone companies. It is clear from the scoping memo, which required the identification of Kerman's affiliates and their revenues, that the Commission was going to consider the relationship between Kerman and its affiliates.[180]

Furthermore, when it is considering a rate case, the Commission also has a duty pursuant to Pub. Util. Code § 728 to "fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force." (*See also* Pub. Util. Code §§ 701 and 761, cited, *supra*, in footnotes 184 and 185.)

In R.92-08-008, the Commission has also spoken decades ago about its duty to review affiliate transaction rules in a general rate case such as the instant proceeding:

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[180] Our conclusion also distinguishes the instant proceeding from the one discussed in *Southern California Edison Co. v. Public Utilities Commission* (2006) 140 Cal.App.4th 1085, 1106, which Kerman relies on in its Reply Brief at 67. There the Court found that the scoping memo's reference to bid shopping and reverse auction was not broad enough to also encompass the prevailing wage proposal. *Southern* also found that the late notice of the new issue was prejudicial since "three business days was insufficient time for the parties to comment on the issues raised by the proposals, including issues of public policy, economic effects, legal implications, and effective administration and implementation of the proposed new rules." As we explain, *infra*, at § 14.6, there is no similar prejudice to Kerman.

> The utility-affiliate relations of almost all utilities that the Commission regulates are already subject to some form of review through either Commission established reporting requirements or as part of Commission rate-making proceedings….Additionally, the Commission almost always examines affiliate transactions in each utility's General Rate Case (GRC) and in reasonableness and prudency reviews.

As part of its review of GRCs, and in recognition of the need to protect the ratepayers, the Commission has noted that part of its evaluation of the application for a rate increase "has been the development of sufficient accounting, financial, and procedural safeguards to ensure that there are no abuses of the utility-affiliate relationship."[181]

In Decision 92399, this Commission made it clear that "it is axiomatic that one who enters into a regulated business is presumed to know the applicable law and assumes all the risks and responsibilities." (* 3.) Kerman is presumed to know the law and, therefore, was on notice that it was within the Commission's power to adopt affiliate-transaction rules by virtue of the Commission's duty to protect ratepayers, and by the existence of Pub. Util. Code §§ 701, 728, and 761.

14.5.1. The Factual Bases Underlying ORA's Proposals Were Examined at the Evidentiary Hearing Even Though the Proposals Themselves Were Not Presented at the Evidentiary Hearing

We must also address Kerman's claim that ORA did not present its affiliate-transaction proposals at the Evidentiary Hearings. While it is true that ORA's proposals were not presented at the Evidentiary Hearings, as the following chart demonstrates, the subject categories that formed the basis of

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[181] 1992 Cal.PUC LEXIS 576 at *3.

ORAs proposals were raised during the examination of ORA's and of Kerman's witnesses:[182]

Separation of the legal entities	A, Page 49:21-55:11
Separation of books and bank accounts for all transactions	A, Page 64:22-65:6 B, Page 202:20-203:19 B, Page 299:1-17 B, Page 300:1-7 C. Page 525:12-17 C. Page 527:16-528:6
Joint advertising or marketing	B, Page 255:16-256:3 B, Page 257: 7-258:17
Overlapping of employees or responsibilities	A, 67:2-11 A, Page 95:8-26 B, Page 201:12-19 B, Page 217:21-25 B, Page 219:15-20 B, Page 274 :11-275:21 B, Page 278: 21-24 B, Page 279 :14-19 B, Page 310:14-311:3
Joint events, sponsorships, fundraisers, or charitable donations	A, Page 67:26-68:16
Financial transactions conducted at arms-length	A, Page 112: 25-113:19 A, Page 114: 7-115:17 B, Page 241: 26-242:11 B, Page 245 :5-20 B, Page 248: 9-23 B, Page 271-: 28-272:5 B, Page 297:15-298:18 C. Page 474:6-16 C. Page 515-9:12 C. Page 529 :10-18 C. Page 598: 27-599:22

182 A=April 28, 2015 hearing date; B=April 29, 2015 hearing date; C=May 8, 2015 hearing date; and D= May 12, 2015 hearing date.

Tellingly, at no time during the Evidentiary Hearings did Kerman object to this line of examination as being beyond the scope of the proceeding.

To the contrary, Kerman went on the offensive and presented testimony in support of its corporate-affiliate structure. In response to the charge in ORA's report that Kerman has "a tangle of business records that are difficult to segregate,"[183] Kerman presented the rebuttal testimony of William Barcus, Kerman's president and vice president of Sebastian, Kerman's parent company, who stated:

> ORA fails to mention the hundreds of hours that Kerman employees spent as part of this rate case to provide detailed information to ORA regarding Kerman's finances and walk through Kerman's records. In reality, Kerman's finances are organized just as the FCC accounting and separations rules require, and the complexity is a natural consequence of compliance with those rules.[184]

In sum, an examination of the four days of testimony reveals that Kerman's relationship with its affiliates was an issue that both parties had an opportunity to explore at the Evidentiary Hearings. It was within the scope of the Commission's authority to consider proposals that impact Kerman and its affiliates.

14.6. Kerman Has Failed to Demonstrate Prejudice (i.e., a Denial of Due Process)

Finally, even if one were to accept Kerman's claim that it was denied the opportunity to question ORA's witnesses, we must also address the issue of how was Kerman prejudiced. In *PG&E*, the Court recognized that in

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[183] ORA-1(a) at 3:3-4.

[184] KTC-2 at 4:8-12.

administrative proceedings, "'a variance between the allegations of a pleading and the proof will not be deemed material unless it has actually misled the adverse party to his prejudice in maintaining his action or defense on the merits, and a variance may be disregarded when the action has been as fully and fairly tried on the merits as though the variance had not existed.'" (237 Cal.App.4th at 862, quoting *Stearns v. Fair Employment Practice Com.* (1971) 6 Cal.3d 205, 213.) Applied to the instant proceeding, the variance between the scoping memo, Evidentiary Hearing testimony, and the recommendation in ORA's Opening Brief will be disregarded if the adverse party has not been misled to its prejudice.

When we speak of prejudice in an administrative proceeding, the question we are considering is whether the party claiming prejudice has been denied due process, a concept that the United States Supreme Court has recognized is difficult to define by a rigid set of principles. (See *Wolff v. McDonald* (1974) 418 U.S. 539, 560 ["The very nature of due process negates any concept of inflexible procedures universally applicable to every imaginable situation."]) This is especially true in administrative actions, where the Supreme Court has recognized that the "origin and function of administrative agencies 'preclude wholesale transplantation of the rules of procedure, trial, and review which have evolved from the history and experience of courts.'" (*Matthews v. Eldridge* (1976) 424 U.S. 319, 348, quoting *FCC v. Pottsville Broadcasting Company* (1940) 309 U.S. 134, 143.) Nevertheless, from a review of the authorities, it appears that in the administrative context, due process has two components: adequate notice and a reasonable opportunity to be heard. (*See, e.g., Goss v. Lopez* (1975) 419 U.S. 565, 579 and 581; and *Matthews, supra*, 424 U.S. at 333 ["The fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'" Quoting *Armstrong v. Manzo* (1965) 380 U.S. 545, 552.])

14.6.1. Adequate Notice vs. Reasonable Notice

We do not see a material difference between the concept of reasonable notice as used by the California Court of Appeal in PG&E, discussed supra, and the concept of adequate notice that has been developed by the United States Supreme Court. Both concepts require a determination of whether the complaining party was made aware of the issue or charge that the administrative agency has either been asked or legally tasked to determine.

Under either standard, we find that Kerman had received the requisite notice. Generally, Kerman was aware that the Commission has the authority to impose affiliate transaction requirements and, as Kerman acknowledges, the Commission has imposed such requirements on Kerman in prior decisions.[185] Kerman's witnesses were examined about the predicate bases for ORA's proposals. Specifically, Kerman was made aware of ORA's proposal that was made in the June 29, 2015 post-hearing legal briefing and had until July 17, 2015 in which to present its position.

14.6.2. Opportunity to be Heard at a Reasonable Time and Manner

Here, Kerman also fails to make a credible showing of prejudice. Kerman alleges that it was denied the opportunity to have examined any of ORA's witnesses regarding the basis for its affiliate-transaction proposals.[186] In making this argument, Kerman assumes that in all instances where there is an issue or

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[185] Kerman Reply Brief at 67.

[186] Kerman Reply Brief at 68.

proposal before the Commission, there will be an opportunity for cross examination in order to satisfy the requirements of due process. We are not aware of such a hard and fast rule, and the United States Supreme Court has not adopted such a rule to apply in all civil administrative proceedings.[187] In fact, in *Bennett v. National Transportation Safety Board* (10th Cir. 1995) 55 F.3d 495, 501, the Court questioned the applicability of the right to confront witnesses in all administrative proceedings: "Of course Bennett's invocation of the Confrontation Clause speaks only of 'all criminal prosecutions." That constitutional right does not apply to civil administrative matters generally."[188] Instead, in civil administrative actions, the United States Supreme Court has recognized that something less than a full evidentiary hearing is sufficient for due process purposes prior to the rendering of an adverse administrative action. Instead, a review of the authorities reveals that the concept of the opportunity to be heard is fluid and can mean either something less than a full evidentiary hearing where there are no genuine issues of material fact to be determined by the particular issue;[189] the opportunity to be heard through the presentation of

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[187] For example, in *Boddie v. Connecticut* (1971) 401 U.S. 371, 378, the Court observed that the "formality and procedural requisites for the hearing can vary, depending upon the importance of the interests involved and the nature of the subsequent proceedings." The Court expressed a similar sentiment in *Brock v. Roadway Express, Inc.* (1987) 481 U.S. 252, 261: "[T]he Court has upheld procedures affording less than a full evidentiary hearing if some kind of a hearing ensuring an effective initial check against mistaken decisions is provided before the deprivation occurs, and a prompt opportunity for complete administrative and judicial review is available."

[188] *See also Hannah v. Larche* (1960) 363 U.S. 420, 440, footnote 16 (The Sixth Amendment "is specifically limited to criminal prosecutions, and the proceedings of the Commission clearly do not fall within that category."); *Renchenski v. Williams* (3rd Cir. 2010) 622 F.3d 315, 336 (citing *Hannah*); and *Denius v. Dunlap* (7th Cir. 2000) 209 F.3d 944, 953 (same).

[189] *See Matter of Grand Jury Proceedings Empanelled May 1988* (7th Cir. 1989) 894 F.2d 881, 882 (in federal civil contempt proceeding, evidentiary hearing can be held only if there are genuine

Footnote continued on next page

written argument and evidence;[190] or the right to cross examine the author when the author of a report is subject to subpoena and examination.[191] It is also true that if ORA's proposals were in its Staff Report that was proffered at the Evidentiary Hearing, then Kerman would have been entitled to cross-examine the authors.[192]

But ORA's proposals were presented by legal briefing and were based on the record developed at the Evidentiary Hearing, and Kerman has had the opportunity to respond with legal briefing of its own where it has set forth its factual and legal arguments why the Commission should not adopt ORA's proposals. Kerman argues in its Reply Brief that the first three proposals are unnecessary as they "do not appear to reflect any change from current practice

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issues of material fact); and *Landesman v. Board of Regents of State of New York* (1983) 463 N.Y.S. 2d 118, 94 A.D. 2d 827, 829 (" the regents review committee did not abuse its discretion or violate petitioner's due process rights by denying petitioner's request for an evidentiary hearing on the charge against him."

190 *See In Vill. Of Hales Corners v. Larson* (Ct. App. 2009) 320 Wis.2d 485, 2009 Wisc. App. LEXIS 548 at *12_ ("Denial of the opportunity to participate in oral argument, following a party's full participation in the hearing and filing of briefs, does not deny procedural due process."); and *Union State Bank v. Galecki* (Wis.CtApp. 1987) 417 N.W.2d 60, 142 Wis. 2d 118, 126 ("We have found no case suggesting that denial of the opportunity for oral argument, following a party's full participation in the hearing and filing of briefs, is contrary to accepted notions of due process or fair play in administrative hearings.)

191 *See Richardson v. Perales* (1971) 402 U.S. 389, 407 ("The physicians' reports were on file and available for inspection by the claimant and his counsel. And the authors of those reports were known and were subject to subpoena and to the very cross-examination that the claimant asserts he has not enjoyed.")

192 Such a result would be consistent with the right to cross-examine a witness who has offered oral or written testimony. (*See* Evidence Code § 711: "[A] witness can be heard only in the presence and subject to the examination of all the parties to the action, if they choose to attend and examine.")

and are therefore unwarranted[.]"[193] If Kerman's argument is correct, it is unclear what additional showing it would have made had it been able to cross examine ORA's witnesses. As for proposals 4-7, Kerman claims that would constitute dramatic changes from the current practices of nearly all utilities under the Commission's jurisdiction and are contrary to law.[194] This statement is unsupported by any factual or legal showing and will not be given any consideration. Kerman also claims that proposals 4-7 could not be adopted without major disruptions to its operations, and presents arguments to support its position. It is unclear what additional evidence Kerman would have presented at the Evidentiary Hearing. As for proposals 8 and 9, Kerman argues that they are already covered by existing rules governing affiliate transactions, and cites to R.11-11-007, D.03-10-006, and D.93-02-019 in support of its position.[195] As the evaluation of these last two proposals appears to be legal in nature, it is unclear what evidence Kerman would have introduced at the Evidentiary Hearings. In short, Kerman makes no showing of what testimony or evidence it would have offered if the scoping memo and the Evidentiary Hearings expressly identified and addressed ORA's nine proposals regarding Kerman and its affiliates.

Kerman will also have another opportunity to address this and other issues when it appears for oral argument. Pursuant to Rule 13.13 (b), a party in a ratesetting proceeding in which hearings were held has "the right to make a final oral argument before the Commission[.]" Kerman availed itself of this right on

[193] Kerman Reply Brief at 64.

[194] *Id.*

[195] *Id.* at 66.

June 29, 2015, when it requested the right to present final oral argument. Kerman will be free to raise its concerns regarding the ORA affiliate-transaction proposals, or any other issue within the scope of the proceeding.

Finally, we note that Kerman also had the option to move to reopen the record but chose not to invoke that opportunity. Pursuant to Rule 13.14 (b), a motion to set aside submission and reopen the record for the taking of additional evidence:

> shall specify the facts claimed to constitute grounds in justification thereof, including material changes of fact or of law alleged to have occurred since the conclusion of the hearing. It shall contain a brief statement of proposed additional evidence, and explain why such evidence was not previously adduced.

All the arguments that Kerman has set forth in its Reply Brief could have formed the basis for a Motion to Reopen the Record, yet Kerman opted not to avail itself of this procedural vehicle.A party's failure to avail itself of procedural remedies to secure cross-examination can seriously undermine that party's claim of prejudice through the denial of due process.[196] This Commission finds that Kerman has waived it right to claim a denial of its right to cross examine by failing to seek to reopen the record.

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[196] *See Bennett v. National Transportation Safety Board* (19th Cir. 1995) 55 F.3d 495, 502 ("Thus having forgone the available opportunities for cross-examination, he cannot ascribe error on that ground."; and *Valkering, U.S.A., Inc. v. U.S. Department of Agriculture* (8th Cir. 1995) 48 F.3d 305, 308 ("Valkering was not deprived of its right to cross-examine the USDA's witnesses, but rather forfeited that right.")

14.7. ORA's Proposals are Neither Unprecedented nor Inconsistent with Existing Affiliate Transaction Law

Kerman faults ORA for failing to cite a Commission decision that ever adopted the recommendations that ORA now wishes to impose on Kerman.[197] That failure, however, is not fatal to ORA's position or to this Commission's ability to consider such proposals. In fact, our review of ORA's nine proposals reveals that many similar rules were adopted by the Commission in another proceeding involving affiliate transactions—R.05-10-030, Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities and Their Holding Companies and Non-Regulated Affiliates. A side-by-side comparison will demonstrate that D. -12-029 adopted affiliate transaction rules for public utility gas corporations and electric corporations, that are similar in many ways to ORA's proposals:

ORA's Proposals	Appendix A-3 Affiliate Transaction Rules adopted by D.06-12-029
Be held in separate legal entities	V. Separation A. Corporate Entities: A utility, its parent holding company, and its affiliates shall be separate corporate entities. (10)
Maintain separate books for all transactions	V. Separation B. Books and Records: A utility, its parent holding company, and its affiliates shall keep separate books and records. (11)
Maintain separate bank accounts for all	V. Separation

[197] Kerman Reply Brief at 67.

transactions	B. Books and Records: A utility, its parent holding company, and its affiliates shall keep separate books and records. (11)
Have no joint advertising or marketing	V. Separation F. Corporate Identification and Advertising 4. A utility shall not participate in joint advertising or joint marketing with its affiliates. (13)
Have no overlapping of employees or responsibilities	V. Separation G. Employees 1. Except as permitted in Rule V E (corporate support), a utility and its affiliates shall not jointly employ the same employees. This Rule prohibiting joint employees also applies to Board Directors, and corporate officers except for the following circumstances… (14)
Have no joint events, sponsorships, fundraisers, or charitable donations	V. Separation F. Corporate Identification and Advertising 4.b. Except as otherwise provided for by these Rules, a utility shall not participate in any joint activity with its affiliates. The term "joint activities" includes, but is not limited to, advertising, sales, marketing, communications and correspondence with any existing or potential customer; c. A utility shall not participate with its affiliates in trade shows, conferences, or other information or marketing events held in California.
Not transfer any physical assets	III. Nondiscrimination

without first obtaining the necessary approvals from the Commission	B. Affiliate Transactions 1. Resource Procurement. No utility shall engage in resource procurement, as defined in these Rules, from an affiliate without prior approval from the Commission. (7)
Conduct financial transactions with each other at "arms-length"	III. Nondiscrimination B. Affiliate Transactions: Transactions between a utility and its affiliates shall be limited to tariffed products and services, to the sale of goods, property, products or services made generally available by the utility or affiliate to all market participants through an open, competitive bidding process, to the provision of information made generally available by the utility to all market participants, to Commission-approved resource procurement by the utility or as provided for in Rules VD (joint purchases), VE (corporate support) and VII (new products and services) below. (5)
Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to KTC from unaffiliated third parties for similar transactions	III. Nondiscrimination A. No Preferential Treatment Regarding Services Provided by the Utility: Unless otherwise authorized by the Commission or FERC, or permitted by these Rules, a utility shall not: 1. Represent that, as a result of the affiliation with the utility, its affiliates or customers of its affiliates will receive any different treatment by the

	utility than the treatment the utility provides to other, unaffiliated companies or their customers; or 2. Provide its affiliates, or customers of its affiliates, any preference (including but not limited to terms and conditions, pricing, or timing) over non-affiliated suppliers or their customers in the provision of services provided by the utility. (5)

In D.06-12-029, the Commission's actions made it apparent that it has the authority to revise affiliate-transaction rules. In Appendix A-3 to its decision, the Commission explained that the new rules it adopted superseded prior rules and guidelines:

> Existing Commission rules for each utility and its parent holding company shall continue to apply except to the extent they conflict with these Rules. In such cases, these Rules shall supersede prior rules and guidelines[.][198]

Regardless what affiliate rules the Commission may have adopted in the past, the Commission retains its authority to revise those affiliate rules if warranted by the particular factual record. Thus, it is immaterial that ORA's proposals may be different from those that Kerman claims the Commission

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198 D.06-12-029, Appendix A-3 at 4, ¶ F **Existing Rules**. *See also* D.87-12-067, Finding of Fact 124: "In order to best protect ratepayers, it is appropriate to periodically review the effectiveness of Commission-imposed restrictions and guidelines dealing with relationships between Pacific Bell, Pacific Telesis, and the various affiliates and subsidiaries." (*315.)

adopted in D.86-08-015, as modified by D.87-03-065, D.05-05-045, D.93-02-019, and R.92-08-008.[199]

In fact, a closer look at these authorities reveals that they impose no legal or precedential impediment to the Commission's adoption of ORA's proposals. D.86-08-015, as modified by D.87-03-065, and D.05-05-045 were cases in which either Kerman or an affiliate was seeking to obtain control through the acquisition of outstanding stock. Neither case involved a rate increase which would have triggered Kerman's heightened burden of proof and closer scrutiny by the Commission.[200] Given the nature of the transaction, in D.86-08-015, the Commission required that Kerman and any other affiliate company transacting business with it to make all books and records available to the Commission. But the Commission never said that would be the extent of any separation that it would require of Kerman and its affiliates.

Similarly unpersuasive to Kerman's position is D.93-02-019,[201] in which the Commission adopted interim reporting requirements for utility-affiliate transactions in light of the requirements in Pub. Util Code §§ 587 (requiring utilities to submit reports detailing significant transactions between a regulated corporation and every subsidiary or affiliate) and 797 (requiring the Commission to periodically audit all significant transactions covered by § 587). But the

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199 Kerman Reply Brief at 67.

200 The Commission observed as much in D.86-08-015: "Applicant will not engage in unregulated activities which compete with its regulated utility subsidiary nor engage in significant transactions with its regulated utility subsidiary. Therefore, we will approve the application without requiring an extensive showing of benefit to the ratepayers." (3.)

201 *Opinion* rendered in R.92-08-008 (Order Instituting Rulemaking on the Commission's Own Motion to Adopt Reporting Requirements for Electric, Gas, and Telephone Utilities Regarding Their Affiliate Transactions).

Commission never went so far as it say it could not invoke its other statutory to and adopt new proposals to create greater transparency between a regulated utility and its affiliates in order to protect the ratepayer from unreasonable services charges.

Nor have we found any authority to suggest that FCC separation rules preempt this area of the law and prevent the Commission from adopting additional affiliate-transaction proposals involving a LEC such as Kerman.[202] In reviewing the FCC's regulations,[203] we find no provision that the Federal Government has expressly or impliedly preempted the field as to affiliate transactions. In fact, in D.03-10-006,[204] the approved settlement stated that Kerman would comply with existing Commission and FCC affiliate rules, as well as any modifications to same in the future:

> By entering into this Settlement Agreement, Kerman affirms that it shall comply with the provisions of the Commission's Decision Number 93-02-019 establishing reporting requirements pertaining to affiliate transactions and that it shall further comply with rules of the Federal Communications Commission pertaining to affiliate transaction as those rules apply to Kerman and as those rules may be modified in the future.[205]

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[202] Derived from the Supremacy Clause in the United States Constitution (Article VI, Section 2), preemption can be express of implied (through field occupancy or where the enforcement of a state law would frustrate the purpose behind a federal law). (*Altria Group, Inc.* (2008) 555 U.S. 70, 76-77.)

[203] 47 C.F.R. Parts 32 (Uniform System of Accounts for Telecommunications Companies), 36 (Jurisdictional Separations Procedures; Standard Procedures for Separating Telecommunications Property Costs, Revenues, Expenses, Taxes and Reserves for Telecommunications Companies), and 64, Subpart I, § 64.901, *et seq* (Allocation of Costs)

[204] *Opinion Approving Settlement Between Kerman Telephone Company and Office of Ratepayer Advocates*.

[205] *Id*. Appendix B (Settlement Agreement) at B-12, ¶ 14.

Kerman was aware the Commission had concurrent jurisdiction with the FCC as to affiliate-transaction rules when it entered into this prior settlement. Kerman has failed to cite any authority to suggest that that concurrent jurisdiction has been divested, and we conclude that the Commission retains jurisdiction in this area to regulate the affiliate relations of regulated entities in California. In making such a finding, the Commission is exercising its authority to determine if the field in which it regulates by decision is preempted by federal law.[206]

Equally important, we do not see that the adoption of the ORA proposals would conflict in any way with the FCC's requirements. At best, Kerman argues that two of ORA's recommendations are already covered by the existing FCC affiliate rules.[207] If it turns out to be the case that some of the proposed recommendations are already being complied with, Kerman will be able to demonstrate that fact when CD either audits Kerman's records or when Kerman produces its records to CD.

14.8. Kerman Will Not be harmed by the Adoption of ORA's Proposals

With one exception, we are unpersuaded by Kerman's claim of impending harm. Kerman asserts that the proposed restriction on joint marketing and employee responsibilities will significantly increase costs for ratepayers of Kerman's regulated services, which will "be a disaster for Kerman and a disaster for ratepayers."[208] Kerman provides no proof for these claims. Moreover, the

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[206] *See* Decision 95-10-032 at *12: "[W]e can declare that a state statute is not preempted by federal law. We also can declare that requirements imposed only by Commission decisions (and not mandated by statute) are unenforceable due to federal preemption."

[207] Kerman Reply Brief at 65:23-26, and 66:10-15.

[208] Kerman Reply Brief at 69:17-25.

proposals that we adopt today have been applicable to regulated electric companies and regulated gas companies for over nine years. If they would have had such harmful impacts on the regulated utilities, the Commission certainly would have made alterations to the affiliated-transaction requirements. Nevertheless, we believe that there may be a possibility that the prohibition against joint employee responsibilities might adversely impact Kerman's operations, so we will remove this one requirement from the affiliate transactions rules that we adopt in this decision.

We also reject Kerman's argument that the timing of ORA's proposals denied Kerman the opportunity to make its evidentiary showing. Kerman had the right pursuant to Rule 13.14(b) to file a motion to reopen the record for the taking of additional evidence but chose not to do so. Tellingly, at the final oral argument, Kerman's counsel stated that he didn't avail his client of this option because "we didn't think those proposals would be taken seriously, so we didn't do that."[209] We will not now give any consideration to Kerman's speculative claims of harm we it deliberately chose not to utilize the available procedural option to address this claim of harm.

14.9. Kerman is Not Being Discriminated Against

We reject the notion that Kerman is being subjected to unequal treatment before the Commission and that, as a result is being discriminated against. Kerman bases this argument on the fact that D.14-12-084 in R.11-11-007[210] declined to "change the affiliate transaction rules given the apparent success of

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[209] RT (May 11, 2016) 987:26-28.

[210] Order Instituting Rulemaking into the Review of the California High Cost Fund-A Program.

the current rules[.]"[211] Yet Kerman leaves out an important qualifying phrase from D. 14-12-084: the "lack of alternative."[212] When read together, D.14-12-084 opted not to modify the affiliate transaction rules, in part, because no party had suggest any alternatives. In contrast, the Commission has been presented with an alternative to the current affiliate-transaction rules. As R.11-11-007 is an ongoing proceeding, the assigned Commissioner and assigned ALJ can decide if ORA's proposals adopted by this decision should be imposed industry wide.

It is also worth noting that the affiliate-transaction rules are not as static as Kerman would have this Commission believe. D.14-12-084 states that affiliate rules will be revisited in Phase 2 of R.11-11-007: "We, however, are interested in further information on the issue of 'fair-market rates' for affiliate use of regulated networks, and will plan to revisit the fair-market rate issue in Phase 2."[213] Thus, R.11-11-007 is an open proceeding where the Commission may consider industry-wide modifications to affiliate-transaction rules consistent with what are being adopted in this decision.

Accordingly, we adopt ORA's proposals to create greater transparency.

15. ORA's Motion to Compel Production of Unredacted Customer Information

On January 30, 2015, the then assigned ALJ Halligan granted ORA's Motion to Compel Production of Unredacted Customer Information from Kerman. Specifically, the ruling required Kerman to produce lists in Excel format for all customers (including their name, start date, address, phone,

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211 Kerman Reply Brief at 71, quoting D.14-12-084 at 73.

212 D.14-12-084 at 73.

213 *Id.*

number, customer ID code, and service type). ORA requested this data pursuant to Pub. Util. Code § 309.5(e), which authorizes ORA to obtain "any information it deems necessary to perform its duties from any entity regulated by the Commission, " without limitation by confidentiality. Pub. Util. Code § 314(a) also provides that the Commission, each Commissioner, and each officer and person employed by the Commission may at any time, inspect the account, books, papers and documents of any public utility. While Kerman objected to the request, citing the prohibition against releasing customer data in Pub. Util. Code § 2891, the Commission herein affirms the ALJ ruling in part. ORA has the authority pursuant to Pub. Util. Code §§ 309.5 and/or 2891(d)(7) when it requests information from a regulated entity.

16. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with § 311 of the Public Utilities Code and comments are allowed pursuant to Rule 14.3 of the Commission's Rules of Practice and Procedure. Opening comments were received from Kerman and ORA on April 25, 2016. Reply comments were received from Kerman and ORA on May 2, 2016. Substantive revisions were made to Sections 7, 9.2, 11.3, 12.2, and 12.3. Other minor revisions and corrections were made throughout the document.

17. Assignment of Proceeding

Michel P. Florio is the assigned Commissioner and Robert M. Mason III is the assigned ALJ in this proceeding. The case was assigned previously to ALJ Julie Halligan from April 29, 2013 to January of 2016.

Findings of Fact

1. On December 28, 2011, Kerman filed this GRC application requesting review of its revenue requirement and an increase in net intrastate revenues of

$2.957 million, which equated to a CHCF-A draw of $6.49 million for test year 2013.

2. On January 30, 2015, Kerman updated its revenue and expense estimates, forecasting intrastate revenue requirements of $10,274,968 for the 2016 test year, a 28% increase over the past five-year average and an increased CHCF-A subsidy amount of $6,011,945. The request represents an increase of $2,472,220 in CHCF-A support, 70% higher than the 2016-authorized $3,539,725 CHCF-A support.

3. On January 26, 2012, the ORA protested Kerman's GRC application.

4. Kerman then revised its 2016 revenue requirement calculation to $10,442,787 based on the final, audited "end of year" financials, including $7,474,394 in projected operating expenses, a $1,779,871 return on rate base, and $1,188,521 in estimated tax liabilities.

5. ORA recommends that the Commission authorize intrastate revenue requirements totaling $6,602,548 for the 2016 test year. When combined with its forecast of other revenues, ORA calculates a total CHCF-A subsidy of $1,938,638 from the CHCF-A in test year 2016.

6. Kerman requests a 13.63% rate of return maintaining that certain proposed regulatory rules create uncertainty regarding its revenue streams, creating greater risks for its investors and therefore requiring a higher rate of return.

7. Kerman's requested 13.63% cost of capital is substantially higher than the 10% authorized in recent years.

8. ORA recommends a 5.71% cost of capital.

9. A decision in A.15-09-005, the Commission's cost of capital proceeding for the small local exchange carriers is expected later this year.

10. Applying the FCC Corporate Expense Cap will cap the amount of corporate expenditures that can be recovered from the CHCF-A program but will not limit the amount of a company's corporate expenditures.

11. Kerman's argues its proposed corporate expenses should be $1,559,228 or at least the $1,544,761 calculated in its rebuttal testimony.

12. Kerman has not shown that the additional executive compensation of $294,705 is necessary to retain employees and is therefore unreasonable as a justification to exceed the corporate expense cap.

13. Including the salary of a temporary position that has been terminated is unreasonable.

14. Basing the new IS manager's salary on a five-year average of the retired IS manager's salary is reasonable. It allows Kerman to more easily meet the FCC corporate expenses cap by reducing corporate expenses by $38,964.

15. Kerman's corporate expenses of $241,465 for donations, dues, and sponsorships is unreasonable as these activities do not increase safety and reliability for Kerman's customers. The elimination of these expenses will allow Kerman to more easily meet its corporate expense cap.

16. Corporate expenses of $55,716 for a party, retreat and banquet costs are not reasonable. California ratepayers should not be subsidizing parties and retreats.

17. Limiting Kerman's business travel expenses to the state's lodging and per diem rates for corporate expense ratemaking purposes is reasonable.

18. Kerman has not demonstrated why apartment rent should be borne by the ratepayers and it is therefore unreasonable. We continue to disallow the total rent expense of $7,050, whether categorized as a corporate or operational expense, for ratemaking purposes.

19. Kerman affiliate Kertel provides Network Operating Center and Information Technology technician labor network service to Kerman, in the amount of $793,100 per year. SEI bills Kerman $96,975 per year which is allocated to Kerman's total corporate expenses.

20. Kerman could not provide a copy of the contract between Kerman and Kertel for network operations and information technology technician labor. Kerman provided an invoice for $66,091.67.

21. Kerman's requested corporate expense of $96,975 is not supported by documentation regarding the terms and conditions of the contract and is therefore not a justification to exceed the corporate expense cap.

22. Kerman's projected legal expense for 2016 is $525,475.

23. Kerman has not provided sufficient justification for any legal service expenses above the corporate expense cap.

24. ORA argues that Kerman's requested $120,000 for an additional regulatory person is not reasonable and should not be used as a means to justify exceeding the corporate expense cap, because the regulatory manager's time has been split between Kerman and FTC since 2010, and the regulatory manager also spends a portion of his time on Kertel and Audeamus.

25. In additional regulatory manager position is unnecessary and therefore unreasonable.

26. Calculating Kerman's corporate expenses based on the FCC corporate expense cap calculations, using an updated loop number of 4789, is reasonable.

27. Kerman's non-corporate expense includes rent it paid to SEI in the amount of $760,800 per year for its central office building owned by SEI, in addition to taxes and insurance in 2014.

28. Kerman was not able to provide specific information regarding the taxes and insurance for this leased building.

29. In Resolution T-17081, the rent amount allowed by the Commission for ratemaking purposes was $570,941 per year. Given the lack of documentation to support the increase from $592,800 to $760,800 per year, ORA recommends that rent in the amount of $570, 941 is reasonable.

30. Kerman claims that holding it to the terms of the 2008 lease are unreasonable, ignore inflationary adjustments and its rental expense claim of $760,800 is more than reasonable.

31. Kerman's request for $760,800 in central office building rental expense is unreasonable absent supporting documentation.

32. Kerman's unregulated affiliate Kertel provides NOC and IT technician labor to support Kerman's operations and customers.

33. SEI bills Kerman $793,100 per year for this maintenance service and $696,125 per year is allocated to Kerman's total non-corporate expenses.

34. The documentation provided by Kerman for SEI's maintenance service is a monthly invoice.

35. Kerman leases a warehouse facility from its affiliated entities, the Barcus Family Partnership and the S&K Moran Partnership and pays rent in the amount of $17,885.59 to the Barcus Family Partnership and $17,885.59 to the S&K Moran Family Limited Partnership for a total of $35,771.18 per month or $429,254 per year.[214]

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[214] Exhibit ORA-1 at 45.

36. Kerman states that it was unable to find the original executed lease and so re-executed a lease for $382.577.04

37. Kerman was unable to provide an original executed warehouse lease agreement, and the monthly rent paid appears to be well above market rate. The recently re-executed lease was between William Barcus and Ruth Barcus.

38. Kerman's requests for $429,254 or $382,577.04, in warehouse rental expense are unsupported and unreasonable.

39. Kerman reported total company marketing expenses as of December 31, 2014 of $373,069.

40. Marketing expenses were allocated 66.66% to the regulated entities (33.33% each to Foresthill and Kerman) with the remaining 33.33% split between the unregulated affiliates Audeamus and Kertel.

41. It is unreasonable for Kerman to pay a larger, unsubstantiated, share of marketing costs than its unregulated affiliates.

42. Kerman's expenses include a yearly payment of $42,000 to Audeamus, Kerman's broadband affiliate, as a customer retention fee.

43. Kerman should be compensated for finding a customer for Audeamus, not the other way around.

44. The customer retention fee of $42,000 paid by Kerman to Audeamus is unreasonable and disallowed as an expense.

45. Kerman includes $7,050 in non-corporate expense for a corporate apartment.

46. Non-corporate expenses for apartment rental are unreasonable for the same reasons that apartment expenses were found unreasonable as a corporate expense in Section 8.2.8.

47. Raising the basic residential rate to $30 inclusive is reasonable and will increase Kerman's local revenue for 2016 by $102,809.

48. ORA and Kerman agree that raising the basic business rate to $36.30, including the EAS charge, will increase Kerman's local revenue for 2016 by $59,312.

49. ORA recommends that ARC revenue of $19,341 be rolled into business rates.

50. Raising the basic business rate to $36.30, including the EAS and ARC charge is reasonable and will increase Kerman's local revenue for 2016 by $78,653.

51. Kerman and ORA agree on the USF and Intrastate Access revenues.

52. Kerman's projections and ORA acceptance of USF and Intrastate Access revenues is reasonable

53. Kerman offers its employees a 50% discount for phone service.

54. Kerman's 50% employee discount is unreasonable because Kerman's basic service residential rates are already heavily discounted due to the CHCF-A subsidy and only six of Kerman's employees work full time for Kerman.

55. Kerman is undercharging for its customer calling services relative to other carriers, contrary to Pub. Util. Code § 275.6(c)(3).

56. ORA's recommended rates for Kerman's Tariff A-28 custom calling features are reasonable.

57. Kerman charges $1.10 per month for inside wire maintenance service.

58. AT&T and Verizon charge $8.00 and $7.99, respectively, for inside wire maintenance.

59. Other small local exchange carriers' rates for inside wire maintenance range from $1.75 to $5.00 per month.

60. Raising Kerman's rates for inside wire maintenance to $5.00 per month for residential and business customers is reasonable and complies with Pub. Util. Code § 275.6(c)(3).

61. ORA's and Kerman's revised projected growth rates are reasonable.

62. Kerman's explanation of how call waiting caller ID services are provided and represented in its tariff is reasonable.

63. Kerman and ORA agree that 2016 projected revenues should include $2,200 in directory assistance revenue.

64. Kerman and ORA agree that 2016 projected revenues should include $6,306 for anticipated late fees.

65. The costs associated with CPE are not generated by Kerman and therefore, including $6,288 of CPE revenue in Kerman's revenue is unreasonable.

66. Kerman's plans regarding back-up power and information for customers related to a fiber system are adequate and therefore reasonable.

67. Requiring Kerman to amortize the remaining copper depreciation of $350,031 over the five-year implementation of the FTTH project is reasonable.

68. Allowing the net plant OWE balance of $682,768 (average balance minus depreciation) in rate base on the basis that Kerman uses the equipment to provide service to customers is reasonable.

69. The Chamber of Commerce occupies Kerman's Old Central Office Building, but it is unclear if any rent is collected.

70. Kerman should be collecting market rate rent from the Chamber of Commerce and reporting it as income. Kerman's failure to do so is unreasonable.

71. Imputing rental revenue of $33,800 for the Chamber of Commerce occupancy of Kerman's old central office building is reasonable.

72. ORA's makes nine recommendations to separate Kerman's operations from its parent company and its affiliates by requiring Kerman and its affiliates to do the following:

1. Be held in separate legal entities.
2. Maintain separate books for all transactions.
3. Maintain separate bank accounts for all transactions.
4. Have no joint advertising or marketing.
5. Have no joint events, sponsorships, fundraisers, or charitable donations.
6. Not transfer any physical assets without first obtaining the necessary approvals from the Commission.
7. Conduct financial transactions with each other at "arms-length."
8. Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to Kerman from unaffiliated third parties for similar transactions.

73. Kerman is wholly owned by Sebastian Enterprises, Inc. (SEI) and operates under the fictitious business name Sebastian. SEI is the parent company of four affiliates: Kerman, Foresthill, Audeamus, and Kertel.

74. Kerman's affiliates are Sebastian Enterprises, Inc. (SEI)—parent company, Foresthill Telephone Co., Kertel Communications, Inc., Audeamus, CVIN, LLC, S&K Moran Limited Partnership, and Barcus Family Limited Partnership."

75. Kerman and Foresthill are rural incumbent local exchange telephone companies that provide regulated local exchange telephone service and related services.

76. Audeamus provides toll service and a range of what it terms non-regulated services such as video, Digital Subscriber Line, and alarm system services.

77. Kertel is a construction company that provides electrical and low voltage construction and non-telecom-related services.

78. Kerman and the other subsidiaries do business as Sebastian.

79. SEI is a holding company for Kerman Telephone Company and Foresthill Telephone Company.

80. Kerman, Kertel, Foresthill, and Audeamus use trucks marked Sebastian.

81. Certain event sponsorships are done under the name Sebastian.

82. Kerman fails to demonstrate that Kerman's procurement of construction through its affiliate is at arms-length and is not creating a burden for the consumer.

83. On February 26, 2016, the Commission issued D.16-02-022, which granted Kerman's Third Motion for Interim Rate Relief, subject to true-up. The interim relief was set at $1,112,373 and payable from CHCF-A.

Conclusions of Law

1. Kerman's application should be granted as modified by this decision.

2. The Commission should decline to adopt a new cost of capital for Kerman in this proceeding.

3. Kerman's cost of capital should remain at 10% until a decision is issued in A.15-09-005.

4. Kerman's additional executive compensation is unreasonable as a justification to exceed the corporate expense cap and should not be adopted.

5. Including compensation in corporate expenses for a position that no longer exists is unreasonable and should not be adopted.

6. Kerman's justification for the new IS manager's salary is insufficient to warrant an adjustment to the corporate expense cap and is therefore unreasonable and should not be adopted.

7. Kerman paying Calcom membership fees of $14,857 is unreasonable and should not be adopted.

8. Kerman's corporate expense of $241,465 for donations, dues, and sponsorships is unreasonable and should not be adopted.

9. Kerman's corporate expenses of $55,716 for party, retreat and banquet costs are not reasonable and should not be adopted.

10. Because Kerman draws from the CHCF-A to subsidize its revenues and expenses, limiting Kerman's business travel expenses to the state's lodging and per diem rates for corporate expense ratemaking purposes is reasonable and should be adopted.

11. The corporate apartment rental expense of $7,050 is unreasonable and should not be adopted for ratemaking purposes.

12. Without details of the services contract, Kerman's $96,975 corporate expenses for services provided by its affiliate Kertel, is unreasonable as a justification to exceed the corporate expense cap.

13. Kerman has not provided sufficient justification for any legal expenses to be considered above the corporate expense cap.

14. Kerman's request for another regulatory manager position at $120,000 is unnecessary and therefore unreasonable and should not be adopted.

15. Kerman's total corporate expenses of $1,541,031, (1,530,319 plus the CPI adjustment of $10,712) based on the FCC corporate expense cap calculations using an updated loop number of 4789, is reasonable and should be adopted.

16. The Commission should adopt $570,941 as the reasonable annual rent expense for the central office building, resulting in a reduction of $189,859 in Kerman's total non-corporate expense.

17. The Commission should allow the $696,125 for Kerman's IT maintenance contract in this proceeding, but require an executed contract containing specific information regarding the services to be performed and the rates to be charged by its affiliate Kertel.

18. Kerman's unsupported requests for $429,254 or $382,577.04, in warehouse rental expense are unreasonable and should not be adopted.

19. Kerman's total reported non-corporate expenses should be reduced by $248,302 in marketing expenses. The Commission adopts $82,767, one fourth of Kerman's total marketing expense, as reasonable.

20. The customer retention fee of $42,000 paid by Kerman to Audeamus is unreasonable and should not be adopted.

21. The non-corporate apartment expense of $7,050 is unreasonable and should not be adopted.

22. Raising the basic residential rate to $30 inclusive of the EAS and ARC is reasonable and should be adopted. The new rate will increase Kerman's local revenue for 2016 by $102,809.

23. Raising the basic business service rate to $36.30 inclusive of the EAS and ARC is reasonable and should be adopted. The new rate will increase Kerman's local revenue for 2016 by $78,653.

24. Kerman's projections and ORA's acceptance of USF and Intrastate Access revenues are reasonable and should be adopted.

25. Kerman's 50% employee discount is unreasonable and should not be adopted. This results in an additional $5,172 in local network revenues.

26. ORA's recommended rates for Kerman's Tariff A-28 custom calling features is reasonable and should be adopted. The rates increase Kerman's 2016 local network revenue projections by $101,761.

27. Raising Kerman's inside wire maintenance rates to $5.00 per month for residential and business customers, comparable to AT&T's and Verizon's rates, is reasonable and should be adopted. Raising the rates increases Kerman's 2016 local network revenue projections by $61,841.

28. The revised projected growth rates are reasonable and should be adopted. The adjusted growth rates result in increased revenue of $17,766.

29. Kerman's explanation of how call waiting caller ID services are provided and represented in its tariff is reasonable and no new rates should be adopted.

30. The parties' recommendation regarding adding $2,200 in directory assistance revenue is reasonable and should be adopted.

31. The parties' recommendation regarding $6,306 in late fee revenue is reasonable and should be adopted.

32. Including $6,288 of CPE revenue in Kerman's revenue is unreasonable and should not be adopted.

33. Kerman's plans regarding back-up power and information for customers regarding a fiber system are reasonable and no additional reporting is required.

34. Kerman should amortize the remaining copper depreciation of $350,031 over the five year implementation of the FTTH project.

35. The net plant balance of $682,768 (average balance minus depreciation) recorded in the OWE should be adopted.

36. Imputing rental revenue of $33,800 for the Chamber of Commerce occupancy of Kerman's Old Central Office Building is reasonable and should be adopted.

37. Kerman has failed to meet its burden of proving that the current corporate affiliations are at arms-length and have not placed a burden on the consumer.

38. Kerman was given notice that the Commission might consider affiliate relations and transactions in this proceeding.

39. Adoption of ORA's affiliate transaction proposals is consistent with this Commission's duty pursuant to Pub. Util. Code § 728 to "fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force."

40. Since Kerman was on notice that the Commission might consider affiliate relations and transactions in this proceeding, Kerman has not been prejudiced by the Commission's consideration and adoption of ORA's proposal regarding affiliate transactions, and the affiliate transactions proposals are consistent with existing affiliate transaction law.

41. The Commission's ability to adopt ORA's proposal regarding affiliate transactions is not preempted by federal law.

42. Even with the presence of the ongoing Rulemaking 11-11-007, Kerman is not being subject to unequal treatment before the Commission because this decision is based on the evidence developed at this proceeding's Evidentiary Hearing.

O R D E R

IT IS ORDERED that:

1. Kerman Telephone Company's application for review of intrastate rates and charges and rate of return for telephone services in California is granted as set forth below and the accompanying Appendix A:

   a) Kerman Telephone Company's operating revenues shall be $9,396,648.

b) As part of its operating revenues, Kerman Telephone Company's total California High Cost Fund-A adopted support shall be $4,778,669.

c) Kerman Telephone Company's operating expenses shall be $7,420,166.

d) Kerman Telephone Company's rate base shall be $12,621,990.

e) Kerman Telephone Company's rate of return shall remain 10% until a decision is issued in A.15-09-055, the Commission's cost of capital proceeding for small local exchange carriers.

2. Kerman Telephone Company shall file a Tier 3 Advice Letter to true-up the difference between interim rates, including 2016 California High Cost Fund-A support and interim rate relief, for the period January 1, 2016 to the implementation date of the rates adopted in this order, in compliance with General Order 96-B, Industry Rule 7.3(5), an update by a GRC-LEC regarding its allocation from the high cost fund.

3. Kerman Telephone Company shall modify its tariffs to charge:

a) Basic residential rates of $30.00 per month and basic business service rates of $36.30 per month. These rates are inclusive of the Extended Area Service Charge and the Access Recovery Charge.

b) Increased rates for custom calling features such as call waiting and caller ID as set forth in Appendix A, that are reasonably comparable to the rates urban customers pay, pursuant to Pub. Util. Code §275.5(c) (3).

4. In order for service or maintenance contract expenses to be considered in future rate cases, Kerman shall provide fully executed written contracts for the services. The contracts for services shall include a description of the materials and services provided and the charges for such materials and services. Additionally, Kerman shall keep records of all materials provided under the contracts, the number of hours worked, services performed and the charges for

those services so that the reasonableness of the service contract expenses can be verified.

5. In order for any rental expense to be included in future general rate cases, Kerman shall provide a fully executed written lease or rental agreement, including provisions for future rate escalations. Additionally, Kerman shall provide no less than three examples of comparable warehouse or office space for rent in the Kerman area to support the reasonableness of its rental expense.

6. Kerman must charge market rates comparable to equipment rental company rates in the Fresno area when renting equipment to Kertel or any other affiliate or non-affiliated entity. A rental agreement or ticket must be created for every instance of Kerman renting Other Work Equipment (including the equipment listed in the Rebuttal Testimony of Eric Kehler, dated April 16, 2015, Attachment EK-3) stating:

- Who is renting the equipment;
- What equipment is being rented;
- When is the equipment rented;
- The rental rate; and,
- How long the equipment is rented.

The rental agreement or ticket must be more than an accounting entry. All documentation must be available to Commission staff to review at any time and retained until after the next general rate case.

7. The Office of Ratepayer Advocates' proposal for revising the affiliate transaction rules as they relate to Kerman Telephone Company (Kerman) and its affiliates is granted. Within 60 days after this decision is issued, Kerman and its affiliates shall accomplish the following:

- Be held in separate legal entities.

- Maintain separate books for all transactions.
- Maintain separate bank accounts for all transactions.
- Have no joint advertising or marketing.
- Have no joint events, sponsorships, fundraisers, or charitable donations.
- Not transfer any physical assets without first obtaining the necessary approvals from the Commission.
- Conduct financial transactions with each other at "arms-length."
- Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to Kerman from unaffiliated third parties for similar transactions.

The January 30, 2015 Administrative Law Judge Ruling Granting the Office of Ratepayer Advocates' (ORA) Motion to Compel is affirmed in part. ORA has the authority pursuant to Pub. Util. Code §§ 309.5 and/or 2891(d)(7) when it requests information from a regulated entity.

8. .

9. All previously filed motions that have not yet been ruled upon are denied

10. No later than 10 days after the effective date of this decision, Kerman shall provide a report to the Commission's Communications Division, and serve the report on the service list of this proceeding, responding to the following questions:

- Does the Kerman Chamber of Commerce rent the Old Central Office Building?
- How much rent does the Chamber of Commerce pay?
- How many square feet is the building and how many square feet does the Chamber of Commerce occupy?
- Are any other tenants of the Old Central Office Building?

- Are there executed leases for occupants of the old Central Office Building? If so, provide copies of the leases.
- If there are no executed leases for tenants of the Old Central Office Building, explain why.
- What is comparable office space leasing for per square foot in Kerman. Provide three examples of office space lease rates in the area

11. Application 11-12-011 is closed.

This order is effective today.

Dated ____________________________, at San Francisco, California.